
ASIAN MONETARY MONITOR

REGIONAL SURVEY: HONG KONG - A LEAD INDICATOR FOR JAPAN?

HONG KONG: THE MYSTERIOUS STRENGTH OF THE HONG KONG DOLLAR.

JAPAN: MONEY, LIQUIDITY AND STOCK PRICES.

PHILIPPINES: WILL INFLATION THREATEN THE TRADE BALANCE?

**EPISODES FROM
ASIAN MONETARY
HISTORY:**

THE CHINESE HYPERINFLATION (PART I)

Vol. 1 No. 1
September - October 1977

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Asian Monetary Monitor is a bimonthly publication specialising in the analysis of economies along the Asian Pacific Rim. Sold by subscription only, price HK\$500 or US\$100 p.a. inclusive of air mail delivery to any part of the world. Correspondence and subscriptions should be addressed to The Editor, Asian Monetary Monitor Ltd., P. O. Box 20724, Causeway Bay, Hong Kong.

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Asian Monetary Monitor is published in

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INTRODUCTORY NOTE TO THE READER

ASIAN MONETARY MONITOR is a bimonthly publication specialising in the analysis of trends and developments in money, banking and finance in the economies of the Asian Pacific Rim. The analysis is centred on aggregate economic statistics, dealing primarily with monetary and fiscal aspects of economic policy in different countries, and the implications of these developments for such critical variables as real economic growth, inflation, the money markets, the balance of payments, the exchange rate and the investment climate. In every edition ASIAN MONETARY MONITOR makes forecasts enabling bankers, investment managers, brokers, or other specialists in financial and business fields to take action while these crucial trends are still in their formative stages.

A SENSE OF PERSPECTIVE

In many countries of the Asian Pacific Rim, vital economic statistics are only at a primitive stage of development, and their collection, collation and interpretation is a major headache to anyone whose business requires him (or her) to keep abreast of overall trends in a number of different economies. Over a period of years the staff of economists and Asian specialists at ASIAN MONETARY MONITOR have carefully collected the longest available consistent data series, frequently stretching back over several economic cycles, in order to provide an invaluable measure of perspective in judging current economic, financial and credit conditions. From these resources, the most up-to-date data have been selected and arranged in a set of unique charts designed to highlight the key relationships determining the direction of aggregate stock price movements, inflation rates, or the exchange rate.

Besides its analysis of current trends and developments, ASIAN MONETARY MONITOR contains two features of particular interest to specialists in Asian finance. The section entitled EPISODES FROM ASIAN MONETARY HISTORY investigates a series of significant historical events which have helped to shape the development of banking and monetary systems in Asia today. In these compact surveys ASIAN MONETARY MONITOR brings together a wealth of specialised knowledge which is often too widely scattered to be easily accessible. The final feature, NEW BOOKS, summarises and reviews new technical publications in the field of Asian finance, banking, economics, investment or business studies.

FUTURE COVERAGE

This is the first issue of what is intended to be a concise but penetrating guide to some of the major economic trends in Asian Pacific Rim countries. Future issues will extend the coverage to Korea, Taiwan, Australia, New Zealand, Indonesia, Thailand, Singapore and Malaysia. Readers are invited to submit any suggestions or comments to the editor and to circulate the publication to other potential readers.

ASIAN MONETARY MONITOR acknowledges a conceptual debt to Monetary Research Ltd., publishers of The Bank Credit Analyst.

REGIONAL SURVEY

HONG KONG — A LEAD INDICATOR FOR JAPAN ?

The economies of the Asian Pacific Rim share many common attributes. Besides having generally above-average growth rates they are frequently each others' fiercest competitors in the major consumer goods markets of Europe and North America. Naturally this gives rise to comparisons of export achievement, but more importantly from an analytical standpoint it leads to a consideration of the common determinants of their overall export performance.

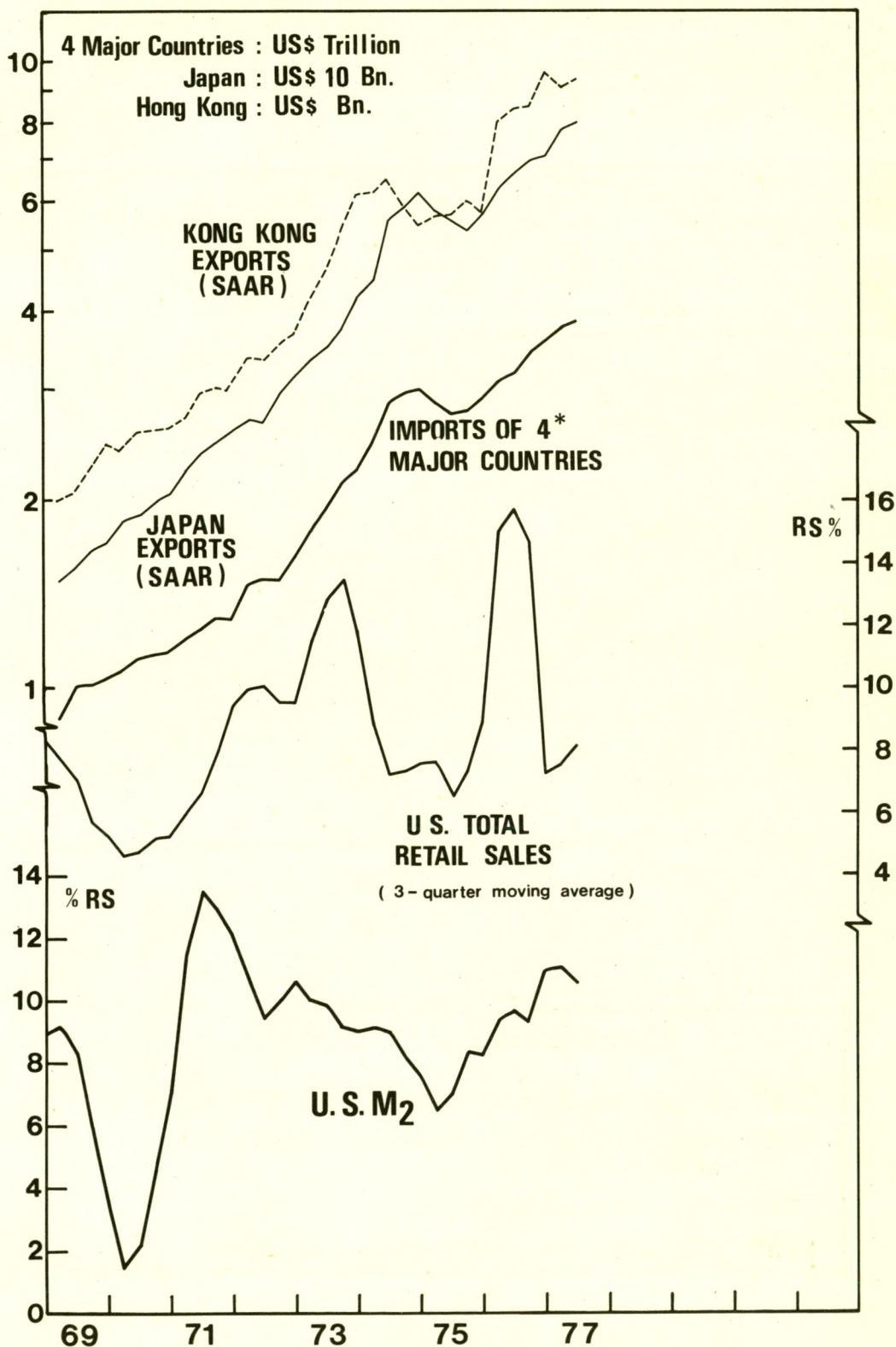
In order to compare the export growth record of Hong Kong and Japan - two of the economies featured elsewhere in this issue - it is necessary first to convert Hong Kong's export figures (normally reported f.o.b. in HK\$) to US\$, and then for convenience to express them on a seasonally adjusted basis at annualised rates (SAAR in the chart opposite). Japan's exports (normally reported f.o.b. in US\$) are expressed in the chart on a seasonally adjusted quarterly basis. It is immediately apparent that over the past nine years the trend rate of growth for the exports of both economies is almost identical, but that the amplitude of fluctuation is apparently greater in the case of Hong Kong. In the mild export slowdown of 1970 and again in the sharp setback of 1974-75 Hong Kong was more noticeably affected. Compared with Hong Kong's 6-quarter export downturn before the really big turnaround in 1976, Japan's downturn continued for just 3 quarters, and since then has risen without interruption. Indeed despite the oil crisis and the upward movement of the yen, Japanese exports in US dollar terms would seem already to have returned to their powerful long-term upward trend. But the really striking observation to be drawn from the chart is that in each case over almost a decade Hong Kong's greater sensitivity is reflected in earlier downswings. This holds good for 1970, for 1971-2, and for 1974. The question is, does the recent downturn in Hong Kong exports imply an impending slowdown or downturn in Japanese exports?

To some extent the answer must depend on the relative severity of any export quotas or other forms of control imposed on the various goods exported by Hong Kong and Japan. But since the US consumer is the main target for both groups of exporters, the answer is going to be determined in a more fundamental sense by (i) the precise nature of the relation between the growth of Total US Retail Sales and US monetary growth (shown in the lower part of the chart) on the one hand, and (ii) the relation between retail sales and exports on the other. Over the past few years US retail sales have grown somewhat erratically varying substantially with consumer confidence in the United States, but in general terms they have tracked the growth of M_2 . In 1969-70 there was an almost coincident relation between the two in terms of timing, but the upsurge of consumer spending in the wake of the explosive growth of money from late 1970 to mid-1971 lagged behind considerably. Also, because US monetary growth continued at a historically high rate through 1972 and 1973 (in the 8-12% range on the chart), there was enormous impetus behind the American consumer spending boom of 1973. As inflation accelerated and money growth slowed further in 1974, retail sales slumped. Starting in early 1975 monetary growth began to pick up again, and, coupled with lower inflation and falling interest rates on consumer credit, by early 1976 there occurred a startling recovery in retail sales, only to be followed by an equally sharp downturn again. Does the late 1976 downturn spell the end of this recovery, or was this only a temporary interruption?

While it is by no means conclusive, especially in view of the widespread concern about the spectre of inflation and the upward trend in

ASIAN PACIFIC RIM

DETERMINANTS OF HONG KONG AND JAPANESE EXPORTS



* USA, W. Germany, France, UK.

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short-term interest rates, the long upward thrust of M_2 suggests that there is an ample reservoir of purchasing power available in the U.S. to fuel another upturn in retail spending. In order effectively to counteract the two-year upswing in money and bring M_2 below the 8% level even by the fourth quarter of 1977 the Fed would now have to restrict the monthly annualised growth rate of M_2 to 6.0% or less on a continuous basis between September and yearend compared with a growth rate so far this year of 10.2%.

FORECAST: Extending this analysis to Hong Kong and Japanese export prospects it seems fair to say that the recent pause in Hong Kong's export growth was in part a delayed response to the 1976 downswing in US retail sales growth, and to that extent reflects a greater sensitivity to US consumer spending patterns, whereas in the Japanese case the downswing has not yet been sufficiently prolonged to have any marked effect on Japan's more diversified product-mix. Moreover, if the observations above concerning the relation between money growth, purchasing power, and US retail sales hold good, the likelihood is that over the next few quarters US consumer spending will remain firmly on the upbeat, and, not so far behind, Hong Kong's exports. And in that case Hong Kong's recent downturn will not be calling the tune for Japan.

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KEY TO SYMBOLS USED IN THE CHARTS

% RP - Percentage Rate of change over Preceding period.

% RS - Percentage Rate of change over Same period of preceding year.

SA - Seasonally Adjusted.

SAAR - Seasonally Adjusted at Annualised Rate.

THE MYSTERIOUS STRENGTH OF THE HONG KONG DOLLAR.*

During the late 1920s the Hong Kong dollar displayed a mysterious strength. Despite the fact that the currency should have been intrinsically synonymous in value with the silver dollar circulating in China or with the Mexican dollar, the currency in fact appreciated substantially relative to the Shanghai silver tael. Instead of trading at a parity of around 72½ Shanghai taels per unit of Hong Kong currency, there was a persistent tendency for the colony's currency to trade at a premium. In 1925 the rate reached 79 taels, and by mid-October 1929 the rate had reached 86½ taels, a premium of some 20%. The strength of the Hong Kong dollar caused substantial and persistent difficulties for Hong Kong's trading community which for several years lost out in the competition with Shanghai until finally in October 1929 parity with silver was restored and silver dollars were permitted to circulate once more within the colony. In the words of Eduard Kann, the eminent authority on oriental currencies, and author of two celebrated articles on Hong Kong currency (see footnote), the effective depreciation of the Hong Kong dollar brought a return to normality which "soon enabled Hong Kong to compete with the Chinese mainland on equal terms." As late as 1956 Kann believed that to the best of his knowledge, "the incident has not been analysed coherently as yet by Hong Kong publications..."

In the present decade of the 1970s the Hong Kong dollar has again been mysteriously strong, and, exactly like their predecessors in the 1920s Hong Kong's traders and industrialists have from time to time expressed their anxiety about the implications of the strength of the currency for Hong Kong's ability to compete in international markets. On an analytical level, too, there has to the best of our knowledge been no comprehensive explanation of this phenomenon by Hong Kong publications. In this brief paper Asian Monetary Monitor therefore attempts to set out the factors behind the secular strength of the Hong Kong dollar together with a consideration of the main reasons for short term deviations from that trend.

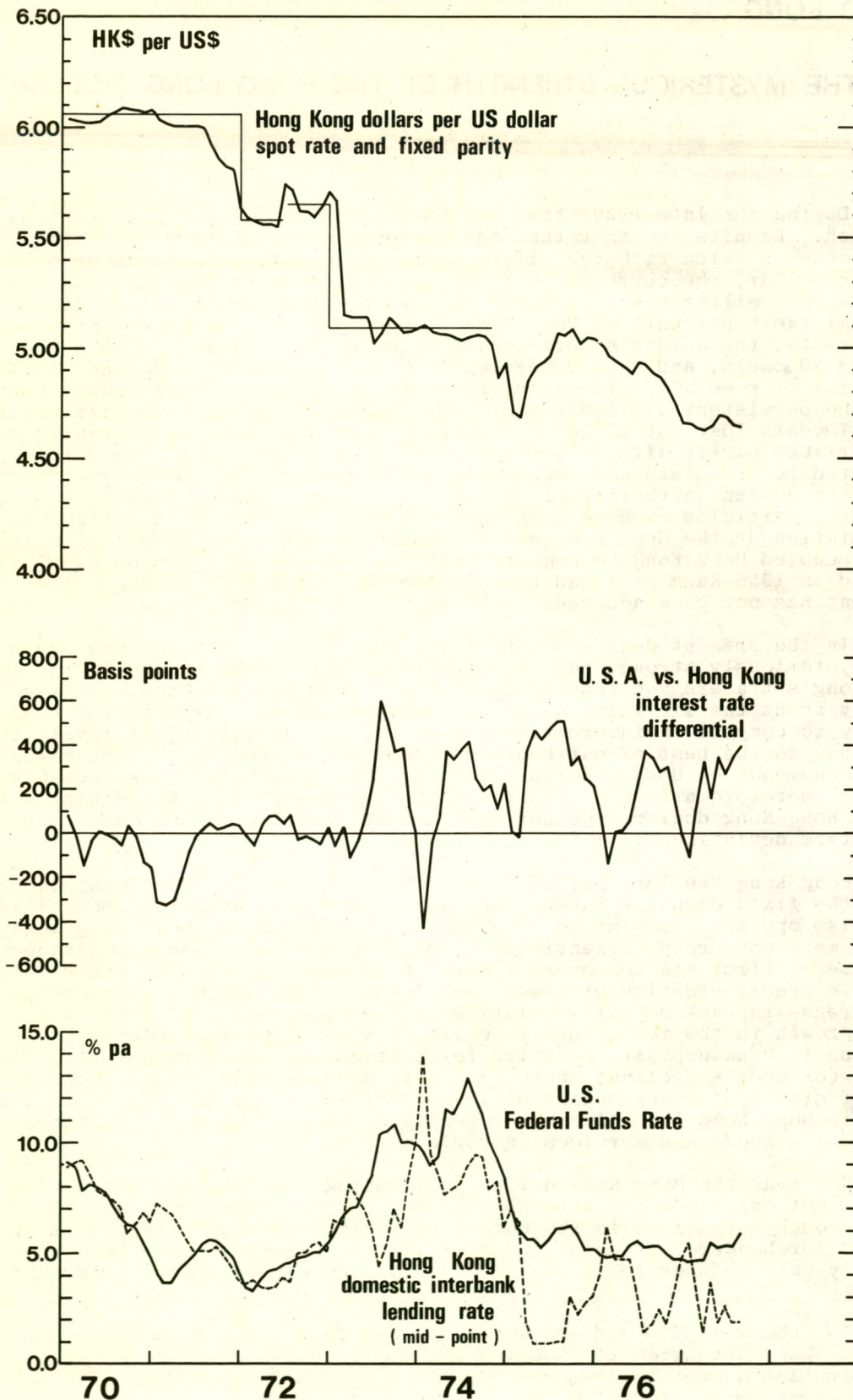
Hong Kong has long prided itself on its automatic adjustment mechanism. Under the fixed exchange rate system which prevailed until November 1974 the mechanism operated, so far as the banking system and the Hong Kong money supply were concerned, essentially through two distinct, but simultaneous processes: first via the overall balance of payments, and second via the domestic credit creation process. Surpluses in the balance of payments or an increase in bank deposits relative to reserves tended to lead to more rapid growth in the money supply, while balance of payments deficits or an increase in bank deposits relative to reserves tended to result in a slower growth (or even a decline) in the domestic money supply. Variations in the rate of growth of money supply ultimately affected the level of prices and wages in Hong Kong which in turn determined the overall competitiveness of Hong Kong's goods and services in world markets.

Now that the Hong Kong dollar is floating the automatic adjustment process not only operates through the two processes described above, but also through variations in the Hong Kong dollar exchange rate. However, the problem for bankers, traders, industrialists, investors and others who actually have to operate in Hong Kong's foreign exchange market is that there

* This choice of title was motivated by two earlier articles on the HK\$ by E. Kann: "The Mystery of the Hong Kong Dollar" (Chinese Economic Journal, Jan. 1930), and "The Strength of the Hong Kong Dollar" (Far Eastern Economic Review, Sept. 1956).

HONG KONG

CHART 1 : RELATIVE INTEREST RATES AND EXCHANGE RATES



would appear to be no entirely satisfactory way of knowing either what the overall balance of payments situation is at any time, or the degree to which the banking system might convert excess reserves into additional money supply, or finally how Hong Kong's existing domestic cost/price structure measures up against that of other competitor economies.

Also, because the automatic adjustment mechanism takes time to work itself out and there are frequent short term disturbances in the foreign exchange markets, it is seldom possible to say with certainty whether the Hong Kong dollar is overvalued or undervalued. Thus even supposing an individual industrialist was capable of accurately assessing the relative competitiveness of his own industry vis-a-vis overseas competitors, he could not reasonably be expected to know whether the Hong Kong dollar was significantly overvalued or undervalued in an aggregate sense, and therefore what his competitive position might be in a few month's time after the automatic adjustment process had worked itself out.

The primary purpose of this study, therefore, is to attempt to explain past movements in the value of the Hong Kong dollar and if possible to predict likely future trends. Since the factors responsible for exchange rate movements vary with the time period under review, two different timescales have been considered, and a hypothesis suggested for each. The first hypothesis we explore is that short term periods of relative strength and weakness in the Hong Kong currency are explained by interest rate differentials while the second hypothesis holds that exchange rate movements over the longer term are primarily determined by relative price changes, according to the principle of purchasing power parity. By examining the second theory we are in effect testing the operation of the automatic adjustment process through the interaction of domestic export prices, foreign prices, and changes in the exchange rate.

Short Term Hypothesis

In an economy where there are no foreign exchange controls, generally free capital movements, and no governmental pegging of the exchange rate, holders of money balances will tend to shift their funds between Hong Kong dollars and foreign currencies in accordance with their expectations of exchange risk and interest yield. For our purposes we shall compare the Hong Kong dollar with the US dollar, the American currency being the most widely utilised medium of exchange in international trade and capital transactions.

In the chart opposite the U.S. Federal Funds Rate is compared with the mid-point of the monthly Hong Kong Domestic Interbank Lending Rate (as two comparable indicators of short term money rates), and the differential is plotted against the Hong Kong dollar. A positive value indicates that interest rates are higher in New York than in Hong Kong, and that funds would tend to be switched into US dollars, thus reducing the value of the Hong Kong dollar. Conversely a negative differential indicates the opposite tendency: funds would tend to be switched into Hong Kong dollars causing the HK\$/US\$ rate to appreciate.

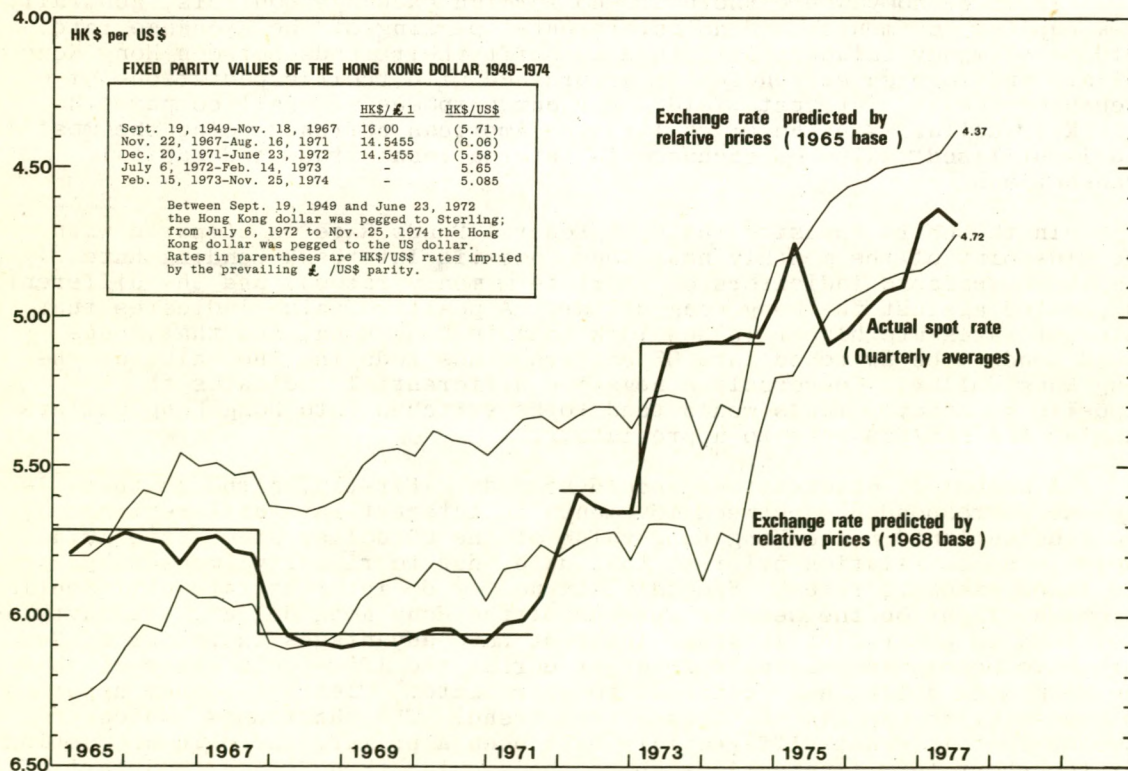
A number of observations should be made. Firstly, although there is a close correspondence between movements in interest rate differentials and fluctuations in the Hong Kong value of the US dollar since late 1974, there is no correlation prior to that date, due to rigidity imposed by the fixed exchange rates. Secondly, in no way do interest rate differentials throw any light on the secular uptrend of the Hong Kong dollar. If anything they tend to contradict it since interest rate advantages in favour of New York have become increasingly frequent during the 1970s. In spite of this the Hong Kong dollar has continued to appreciate. Clearly another hypothesis is necessary to explain the longer term trend. The chart does indicate however that interest differentials have been a primary force in accounting for the short term fluctuations about the secular trend since the start of the era of floating rates.

Long Term Hypothesis

What factors lie behind the longer term strength of Hong Kong's dollar? Correct identification of the causal variables is essential if either explanation of past movements or prediction of future movements is to be possible. Our second hypothesis is that under a system of floating rates the exchange rate against the U.S. dollar is determined by the relative price levels of export goods. The theory is best explained by a simple example. If the prices of Hong Kong's exports rise X% more than the price of United States products, but the exchange rate remains unchanged, then consumers in both Hong Kong and the United States will tend to switch to the American product. The disequilibrium can only be corrected by depreciation of the Hong Kong currency - in this way consumer sovereignty boosts the Greenback at the expense of the Hong Kong dollar - or by domestic financial measures which would result in lowering Hong Kong's relative price level again. To restore equilibrium over the longer term either the exchange rate must move by X% to compensate for shifts in the domestic price levels, or there must be some combination of an exchange rate change and a further change in prices.

Unfortunately, comparisons of relative price levels based on Hong Kong's published export price indices have been singularly unsuccessful in predicting exchange rate movements over the longer term. Also, since the structure of Hong Kong's exports is vastly different to that of internal consumption patterns, the domestic consumer price indices are unsuitable for this purpose. We have therefore constructed an export price index for Hong Kong which excludes the purely domestic components of Hong Kong's prices, but reflects the composition of Hong Kong exports. This index is then compared with the United States wholesale price index as a proxy for the world price level.

HONG KONG
CHART 2 : ACTUAL AND PREDICTED EXCHANGE RATES



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For a proper test, purchasing power parity theory requires the identification of a period during which prices in Hong Kong, prices in the United States, and the HK\$/US\$ exchange rate were all "in equilibrium". One possible criterion for this would be a period of stability in the level of Hong Kong's foreign exchange reserves. Obtaining data for Hong Kong's monetary reserves is a problem, however, due to the secrecy that surrounds this sensitive issue. Consequently an alternative basis for the selection of an equilibrium period has to be found, but rather than trying to pin down such a period too precisely, two base periods have been selected - 1965 and 1968 - years on either side of Hong Kong's domestic disturbances of 1967. No attempt is made to define these dogmatically as equilibrium periods; rather the rationale is empirical. 1965 is the earliest full year for which we have been able to obtain the components of the Consumer Price Indices, while 1968 provides an alternative base period after the November 1967 parity shift. Starting from the 1965 and 1968 base periods, the theory predicts that the exchange rate between HK\$ and US\$ should have moved to compensate for any discrepancy that subsequently developed between the price indices of each country measured in local currency terms. Turning the theory around one may ask: what exchange rate would be required in order to bring the Hong Kong and US price indices back into line with their (assumed) equilibrium levels in 1965 and 1968?

The two thin lines plotted on either side of the exchange rate in Chart 2 represent the results of this calculation for each of the two base periods. Having thus produced an admittedly arbitrary 'equilibrium range', the success of our base periods can be judged in terms of the degree of symmetry of the actual exchange rate about the mid-point of this range. This approach would appear to be a reasonable way of overcoming both the practical and theoretical problems which surround the equilibrium concept.

Given the equilibrium range for the HK\$/US\$ exchange rate shown in Chart 2, an actual exchange rate above the predicted upper limit at any point in time implies that the HK dollar is significantly overvalued and it can be expected to depreciate. Similarly, any deviation below the range suggests that the rate is undervalued and can be expected to appreciate as the automatic adjustment process works itself out. Because the exchange rate has stayed so closely within the predicted range, it seems reasonable to conclude that the hypothesised relationship between relative prices and the exchange rate during the period under consideration does indeed hold good. In other words the exchange rate does, over the longer term, reflect relative international price levels, and cannot be ascribed merely to Hong Kong's individual, domestic idiosyncracies. Popularly held views such as the importance of "hot money" flows, the low tax structure, "cheap labour" or an industrious labour force, cannot on their own provide an adequate explanation of the six-year appreciation in the HK\$/US\$ rate.

Nevertheless, the Hong Kong dollar has fluctuated widely over the period, and has in fact only spent a small proportion of the time - approximately five out of twelve years - within the broadly defined 'equilibrium range'. Interestingly, the traditional system of fixed parities is shown to have been pitifully inadequate, being slow to adjust to a changing economic environment. Each of the three longest lasting parities in this period (at US\$5.71, US\$6.06 and US\$5.085) remained outside the equilibrium limits for most of their duration. Consequently after some interval a sizeable parity change was required, and these major shifts do much to conceal the regularity of pattern that does exist. Admittedly this is partly due to the fact that the HK\$ was pegged against one, rather than a 'basket' of currencies. For example the sudden devaluation of the Hong Kong dollar in November 1967 was due to the Sterling peg, although the currency was not devalued to the same extent as the pound. With the US dollar devaluation of August 15, 1971, the pound appreciated, taking the Hong Kong dollar up to US\$5.58. Renewed weakness of Sterling in June 1972, caused an effective devaluation of 1.2% in the middle of the year. For a two-week period (June 23-July 6) the Hong Kong dollar effectively floated, and was subsequently pegged in terms of US dollars

only to find itself the victim of another devaluation in February 1973. In contrast to the periods of fixed parities it is very interesting to note that since floating began the rate has not deviated by more than 2% beyond the 'equilibrium range' compared to deviations of 3.8% from the lower limit in the first quarter of 1970 or 6.6% from the upper limit in the fourth quarter of 1973.

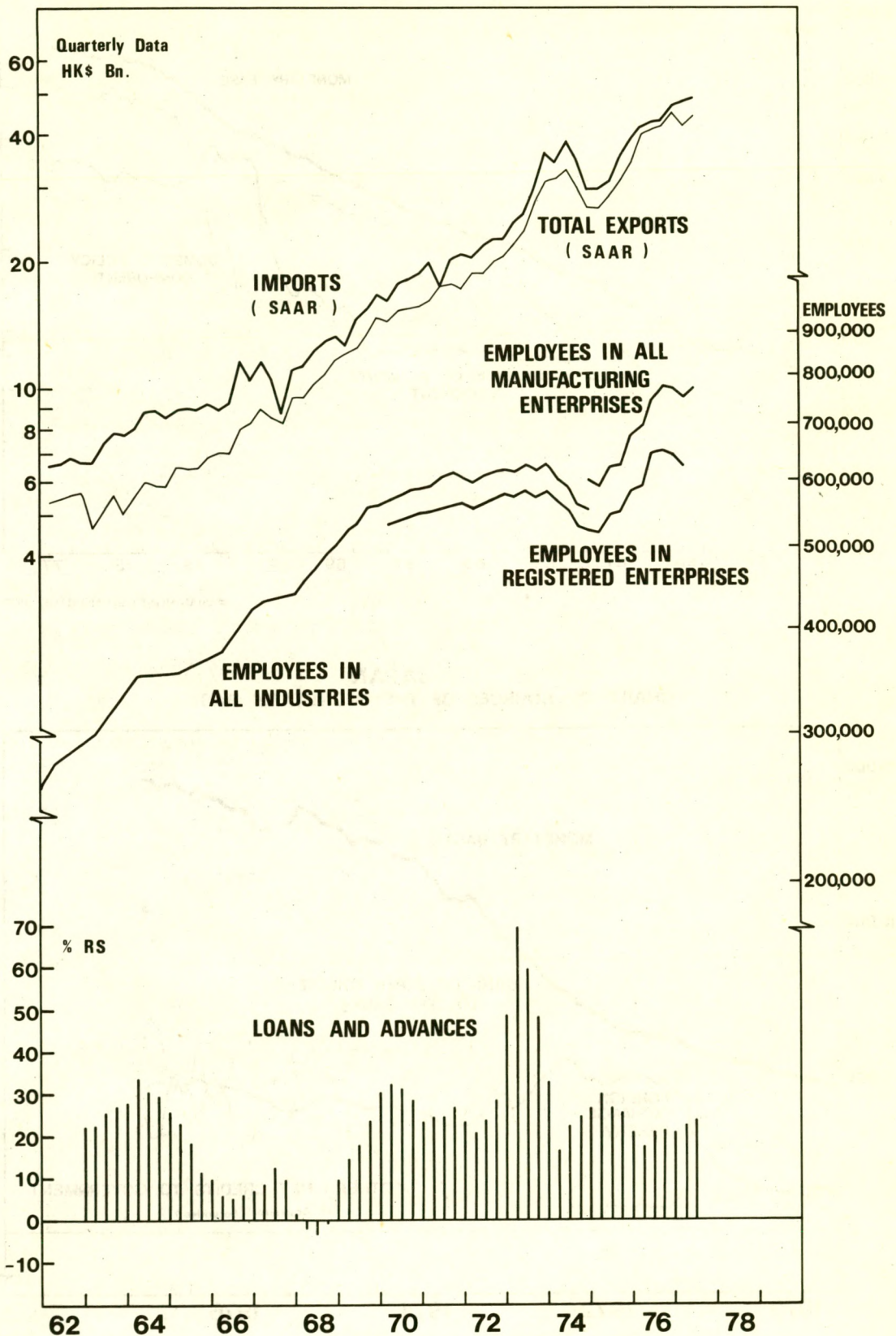
A further interesting observation about the fixed rate era is that between 1965 and 1970 inclusive the pegged rate became progressively more undervalued thus enabling Hong Kong to enjoy a continuous export-led boom. From 1966 to 1970 nominal domestic exports rose by 115%, while over the same period per capita GDP at current prices rose just 54%. In direct contrast is the period from 1971 to 1974 when the appreciation of the Hong Kong dollar culminated in the pegging of the rate at HK\$5.085 per US dollar in the summer of 1973, a fundamental overvaluation as judged by relative prices. This of course deprived Hong Kong of its previous competitive advantage, and during these few years the 67% growth in domestic exports was fairly closely matched by the 56% growth in nominal per capita GDP. Since the advent of floating exchange rates in November 1974 the spot rate has fluctuated on both sides of the equilibrium range, reflecting the ability of the floating rate system to incorporate such short term factors as interest rate differentials in the value of the currency while at the same time taking account of long term fundamentals. At the present time the rate again appears to be moving towards the lower end of the equilibrium range, probably due to the interest rate differential which has emerged between New York and Hong Kong in recent months.

FORECAST: Given this explanatory model for the past behaviour of the Hong Kong dollar it becomes possible to predict future movements in the light of current interest rate differentials and recent price trends. Contrary to a belief sometimes expressed among the financial community or indeed certain textile exporters, the Hong Kong currency is probably not overvalued as a result of its appreciation last winter. Between mid-1975 and late 1976 it appears to have been fundamentally undervalued and its appreciation was encouraged on a short term basis by the narrowing interest rate differential between Hong Kong and New York. Our fundamental export price comparison suggests that, if anything, the Hong Kong dollar is now near the lower end of the equilibrium range again, and that any short term weakness is due to the widening gulf in interest rates, rather than to any fundamental overvaluation. Over the medium to longer term there seems to be little doubt that the Hong Kong dollar will continue to strengthen.

Historically the secular appreciation of the Hong Kong dollar has been due to changes in relative price levels and we expect these to continue to move in favour of Hong Kong. Given the likelihood that the expansionary monetary policy pursued in the United States over the past two years will exert further upward pressure on the American domestic cost structure, as discussed in the Regional Survey, this conclusion seems unavoidable. Seen in perspective therefore any weakness in the Hong Kong dollar due to a further rise in the Federal Funds rates will probably only be temporary, and will merely serve to accentuate the subsequent appreciation of that mysterious currency.

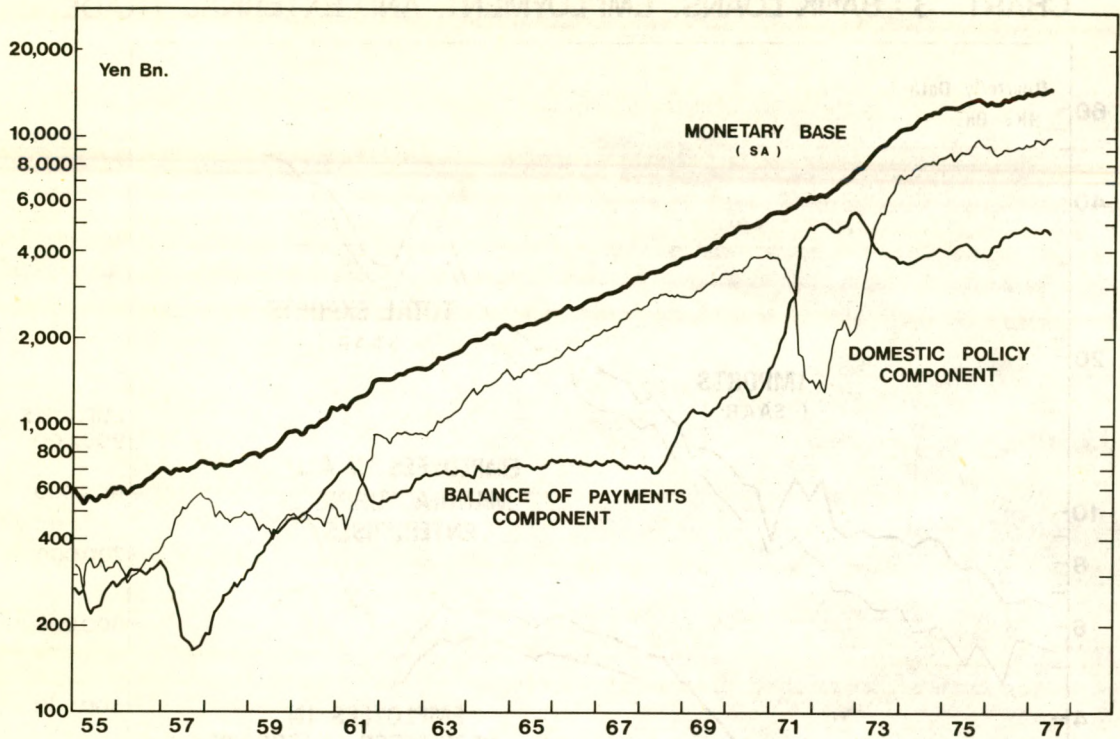
HONG KONG

CHART 3 : BANK LOANS, EMPLOYMENT, AND EXTERNAL TRADE



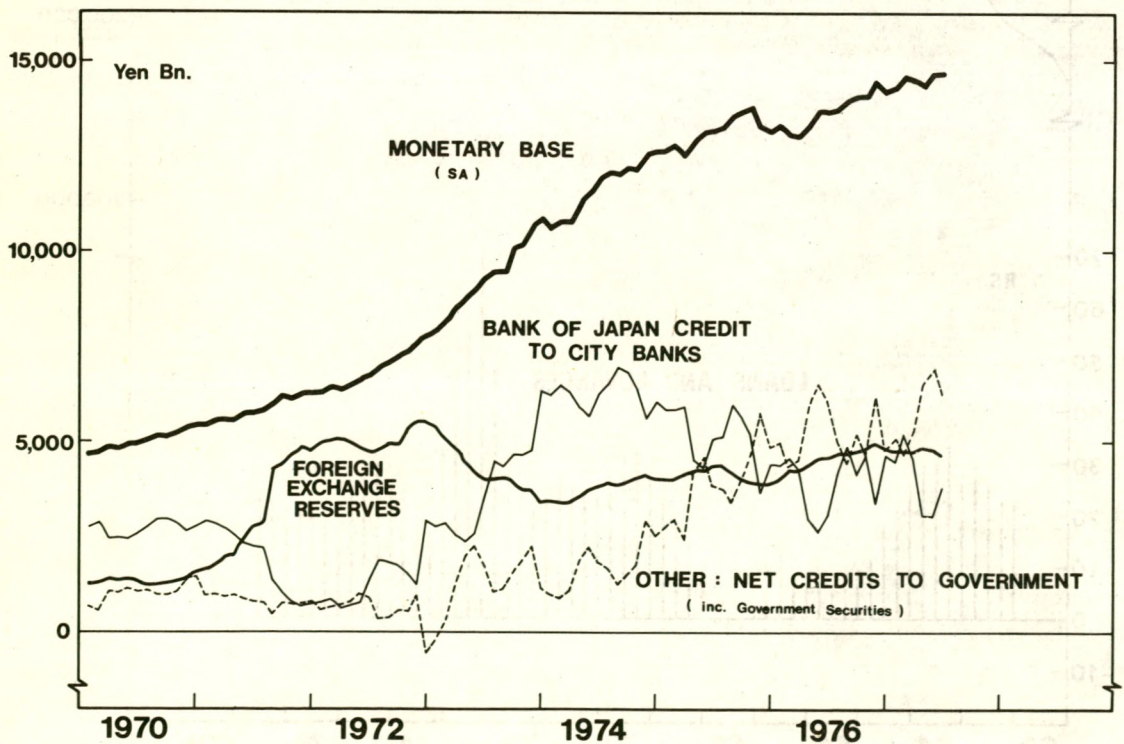
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JAPAN
CHART 1 : MONETARY BASE AND COMPONENTS



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JAPAN
CHART 2 : SOURCES OF THE MONETARY BASE



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MONEY, LIQUIDITY AND STOCK PRICES.

Since July 1974 there has been a fundamental change in the objectives of monetary policy in Japan. As a result there is a marked contrast between the response of the authorities to balance of trade or balance of payments surpluses in the late 1960's or the early 1970's and their response in this cycle. Without a clear understanding of the background to the switch in policy it is hard to explain numerous developments in the Japanese economy. In this first issue, therefore, Asian Monetary Monitor attempts to set out the basic characteristics of the new policy, and examines the consequences of that new policy in terms of selected economic indicators illustrated in Charts 1-6.

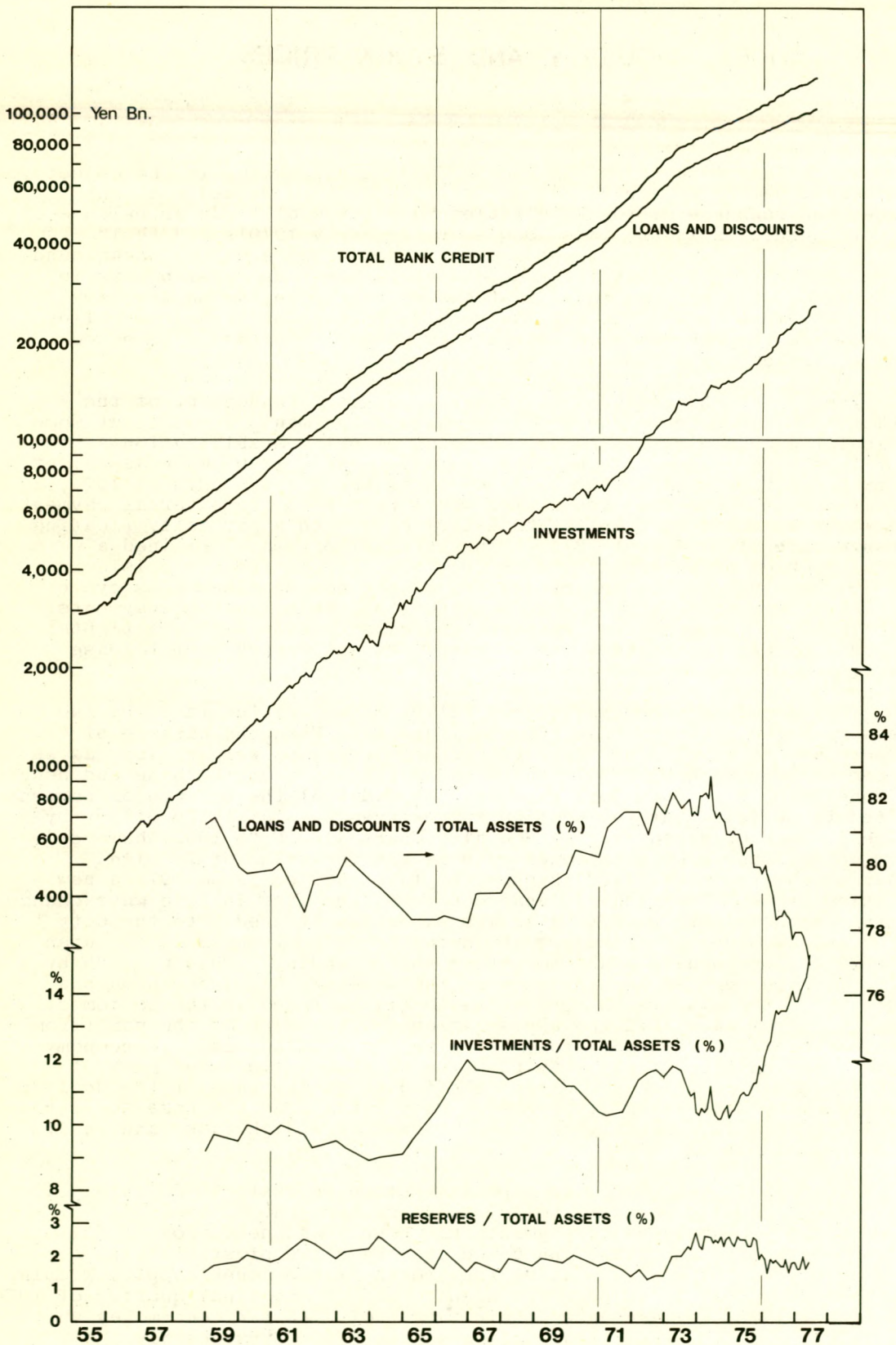
The policy change consists primarily of the abandonment of the attempt to balance the country's international payments accounts at some particular exchange rate, and the adoption of price stabilization as the major objective of domestic economic policy. Since 1949, when Japan set its exchange rate at ¥360 per US\$1.00, until about the middle of 1974, the first concern of the authorities was always with the external payments position. This was so despite the experiments with a partially floating exchange rate after August 1971. Thus external payments remained a central problem of policy during the early months of the oil crisis in late 1973. Consequently the regulation of the domestic business cycle had always been to a large extent dependent on the balance of payments situation. The emergence of payments deficits usually led to a tightening of credit by the authorities, while surpluses encouraged them to ease domestic credit.

This aspect of the traditional policy is well illustrated by the behavior of the monetary base (Charts 1 and 2). When the balance of payments was in surplus and foreign exchange reserves were rising, as in the period 1958 to early 1961, there was a tendency for the base and hence the money supply to grow more rapidly. In mid-1961 the balance of payments shifted to deficit, but the decline in reserves was initially offset by a rise in Bank of Japan credit (See also Chart 4). From 1962, however, the monetary base grew at a lower rate as the yen value of foreign exchange reserves stabilised through the late 1960's. From 1971 a new situation arose: The Bank of Japan countered the rise in foreign exchange reserves with a sharp reduction in its extension of credit to the City Banks, but in order to stimulate the domestic economy the Bank of Japan deliberately encouraged banks to extend their lending. This was achieved not so much through an acceleration of the monetary base, as through a reduction in the reserve-to-deposit ratio (illustrated at the bottom of Chart 3). From late 1972 the appreciation in the value of the yen (from ¥360/US\$ to around ¥265/US\$) together with the booming domestic economy reversed the balance of payments position so that in 1973 the Bank of Japan was again compelled to offset the impact on the base of the decline in reserves by increasing its loans to City Banks. As the base accelerated, especially in 1973, monetary growth continued at a high rate, and in its train inflation took off.

Since 1974, and even more important since February 1975, this policy of allowing domestic monetary policy to be subservient to the exigencies of the balance of payments has been abandoned. For in July 1974 the Bank of Japan first announced its objective of stabilizing domestic prices through regulating the growth of the money supply, keeping it at a 10 per cent to 13 per cent annual rate in the final quarter of 1974. In February 1975 they announced their target of a 15 per cent money supply (M_2) target for the fiscal year ending March 1976. Subsequently the

JAPAN

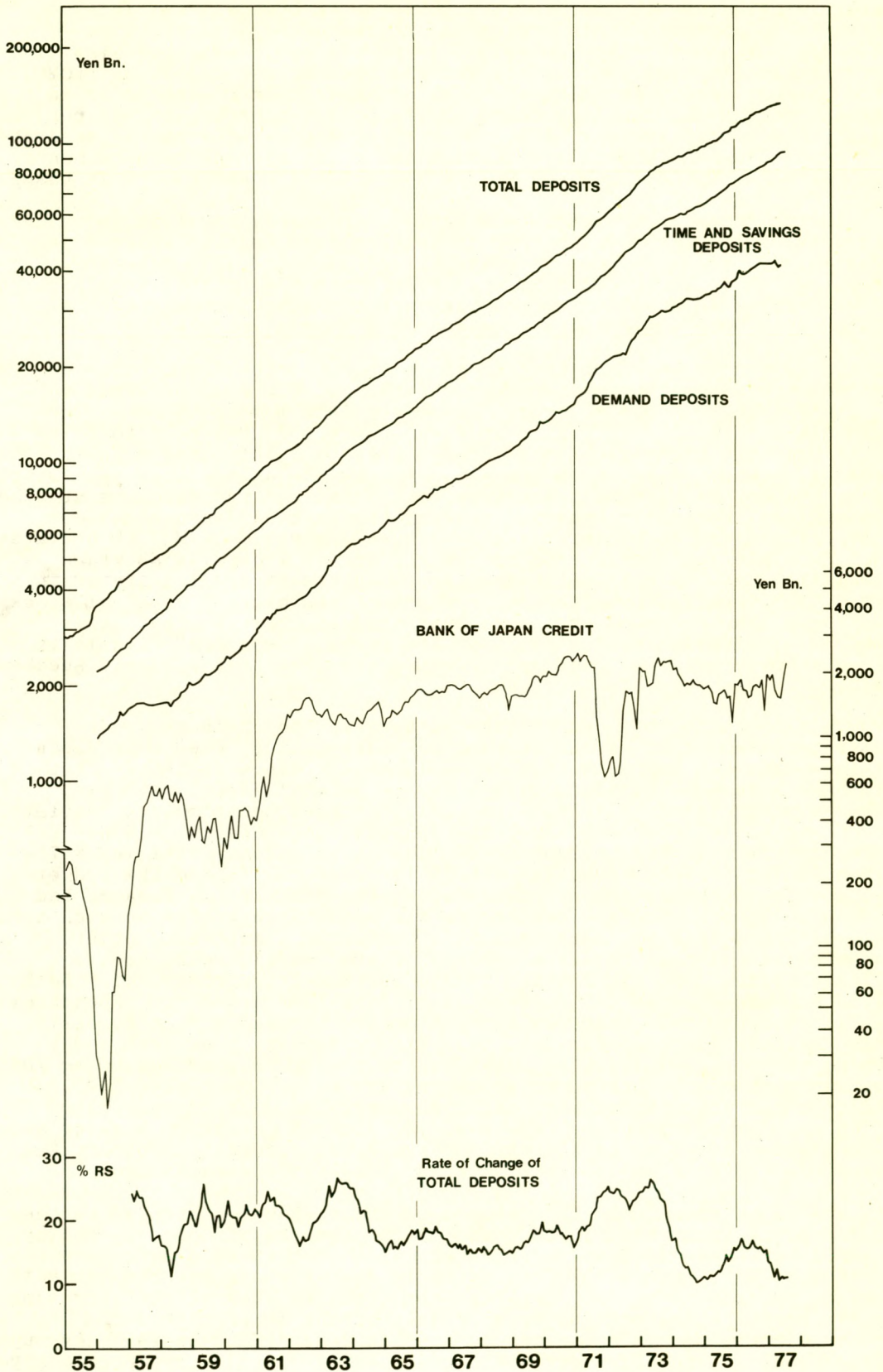
CHART 3 : BANK ASSETS



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JAPAN

CHART 4 : BANK LIABILITIES



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authorities have from time to time let it be known what their implicit monetary growth targets are, but there has never been any explicit commitment in Japan to those targets as there has been in the U.S., W. Germany, or Australia. The reason is partly political, but also partly technical. For, unlike the Federal Open Market Committee (FOMC) in the United States, but like the Bank of England, the Bank of Japan does not publish any regular record of its policy proceedings for public scrutiny. However, in July 1975, the Bank of Japan published a research paper explaining the underlying statistical relationships between money, gross national expenditures and prices, on which the new policy is based.

In the Japanese context, this paper is probably equal in importance to the first directive of the FOMC to the New York Federal Reserve in January, 1970, to pursue quantitative targets for specific monetary aggregates, or to House Congressional Resolution 133 of 1975 requiring the Federal Reserve to restrict monetary growth to rates "commensurate with the economy's long-run potential to increase production".

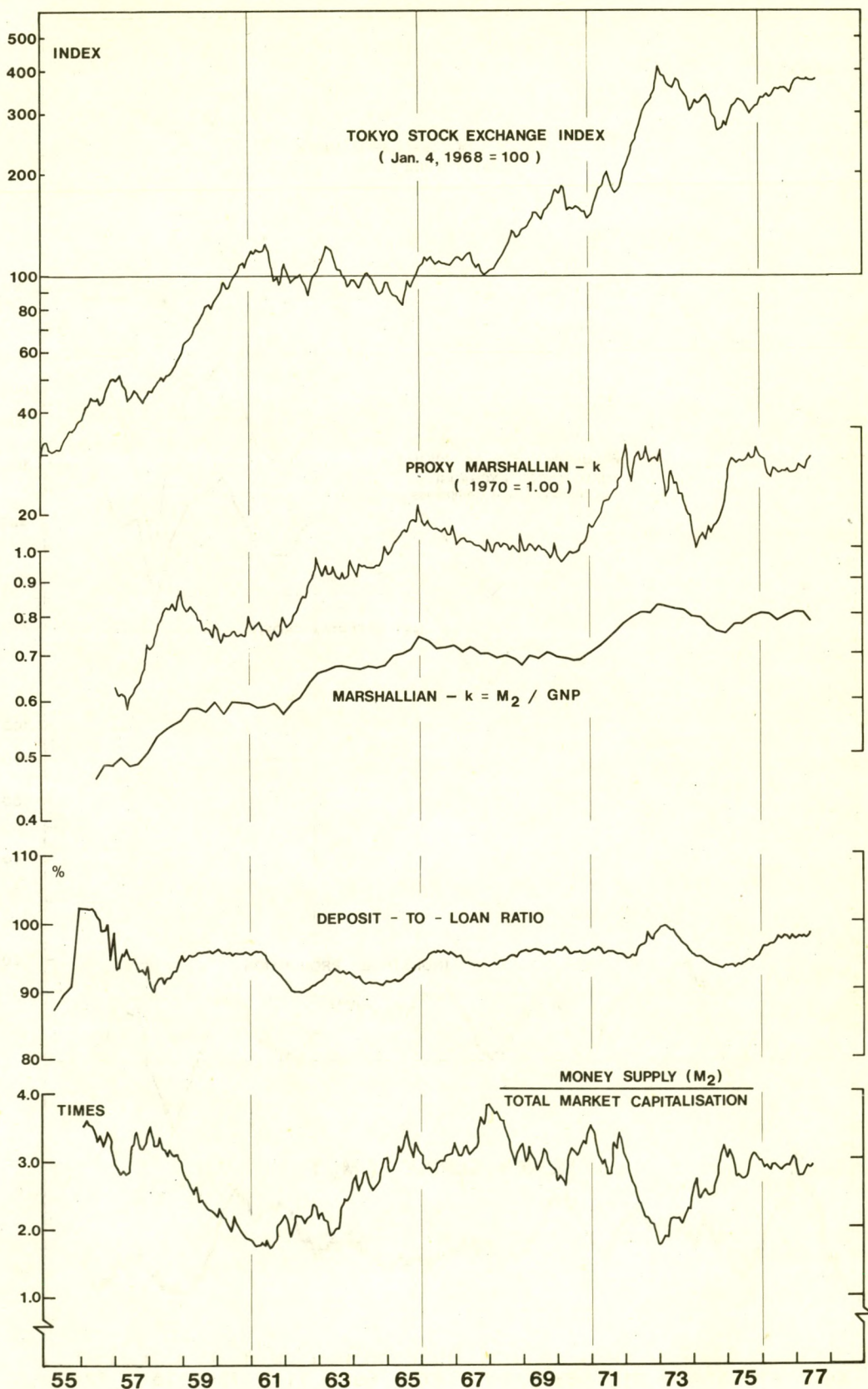
There can be no doubt that in the history of the development of Japanese monetary policy since the foundation of the Bank of Japan in 1882, this change in the objective of policy is a momentous one. The intermediate objective of policy in Japan since 1974 has been to bring the ratio of the broadly-defined money supply (M_2) into line with its historical trend. Also in the past few months the authorities have started to take account of M_3 (which includes postal savings and deposits at other non-bank institutions). Roughly speaking the Bank of Japan considers "excess liquidity" to be the situation where the ratio of M_2 /GNP deviates above its historical trend, and conversely for a "liquidity shortage". The relation between this ratio and the stock market is illustrated in Chart 5. Obviously many other factors affect the overall level of stock prices (e.g. the trend of profits illustrated in Chart 6), but it is extremely interesting to note that in the period since 1970, liquidity defined according to the Bank of Japan's usage has been a highly successful predictor of Japanese stock prices.

Turning to the response of the authorities to the huge trade imbalance in the light of the changed monetary policy, events in Japan over the past year become much more explicable. Since September last year there have been at least five separate sets of fiscal measures announced or implemented, each supposedly designed to stimulate the level of economic activity. In October 1976 passage of a Special Finance Bill in the Diet allowed the government to float bond issues totalling ¥3750 billion in the period before March 1977 in order to finance the budget deficit. In the words of one commentator, the Ministry of Finance had "apparently thrown monetary caution to the winds in deciding on such a vast (¥1300 billion) initial instalment." In November a further 7-point package of fiscal measures was approved centred mainly round boosting housing construction. In January 1977 a supplementary budget of ¥354.2 billion was passed, most of it (¥260.0 billion) earmarked for expenditure on public works, these measures being expected to take effect by April. On March 11th a fourth programme, this time a 4-point plan designed to speed up the placing of public works contracts was adopted requiring 70% of public works contracts to be placed by the end of September 1977. Finally in the very recent past the government has decided on a ¥2000 billion supplementary budget, again giving special favour to housing and public works. Yet despite all these packages, the domestic economy has entirely failed to respond. How is this paradox to be explained?

The major reason for the failure of the economy to respond to the plethora of programmes is to be found in the conduct of monetary policy. For in direct contradiction to whatever may have been said by government spokesmen at last year's IMF Conference in Manila about boosting domestic demand in order to stimulate imports, the irony is that at the very same time the monetary authorities were in fact acting in precisely the opposite direction. As shown in Chart 6, in June 1976 Japan's money supply (M_2) recorded an increase over the corresponding month of the previous year

JAPAN

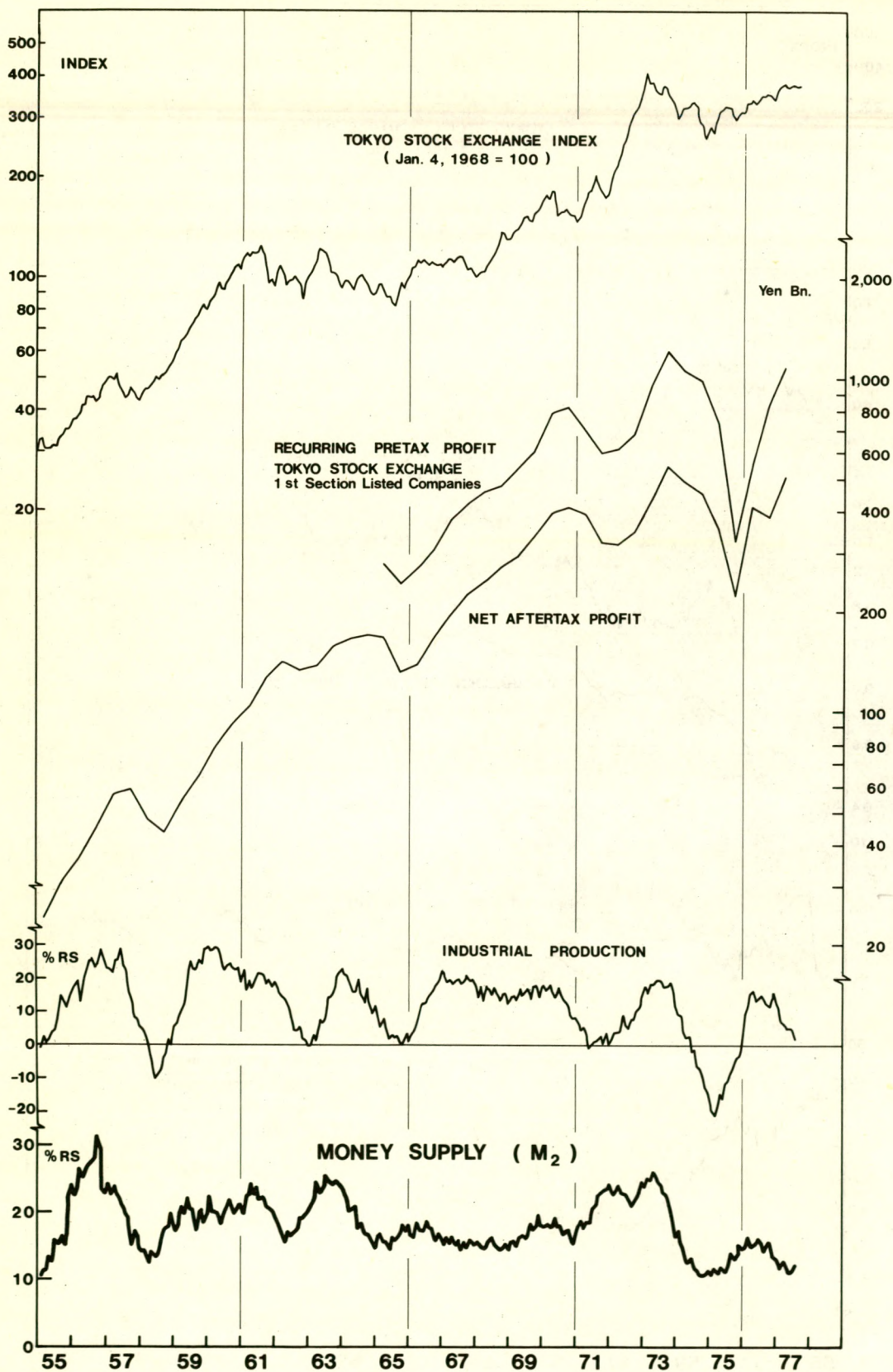
CHART 5 : THE STOCK MARKET AND 4 LIQUIDITY INDICATORS



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JAPAN

CHART 6 : MONEY, OUTPUT, PROFITS AND STOCK PRICES



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of 16.1%. At the end of August the growth had dropped to 14.5%, and by yearend to 13.5%. Nor was this the end of the decline: broadly-defined money supply decelerated to 11.2% in July this year on a month-average basis.

This decline may not seem very dramatic or significant, but it must be remembered that by Japanese standards these growth rates are historically low compared with an average growth rate between 1961 and 1971 of 18.9% per annum.

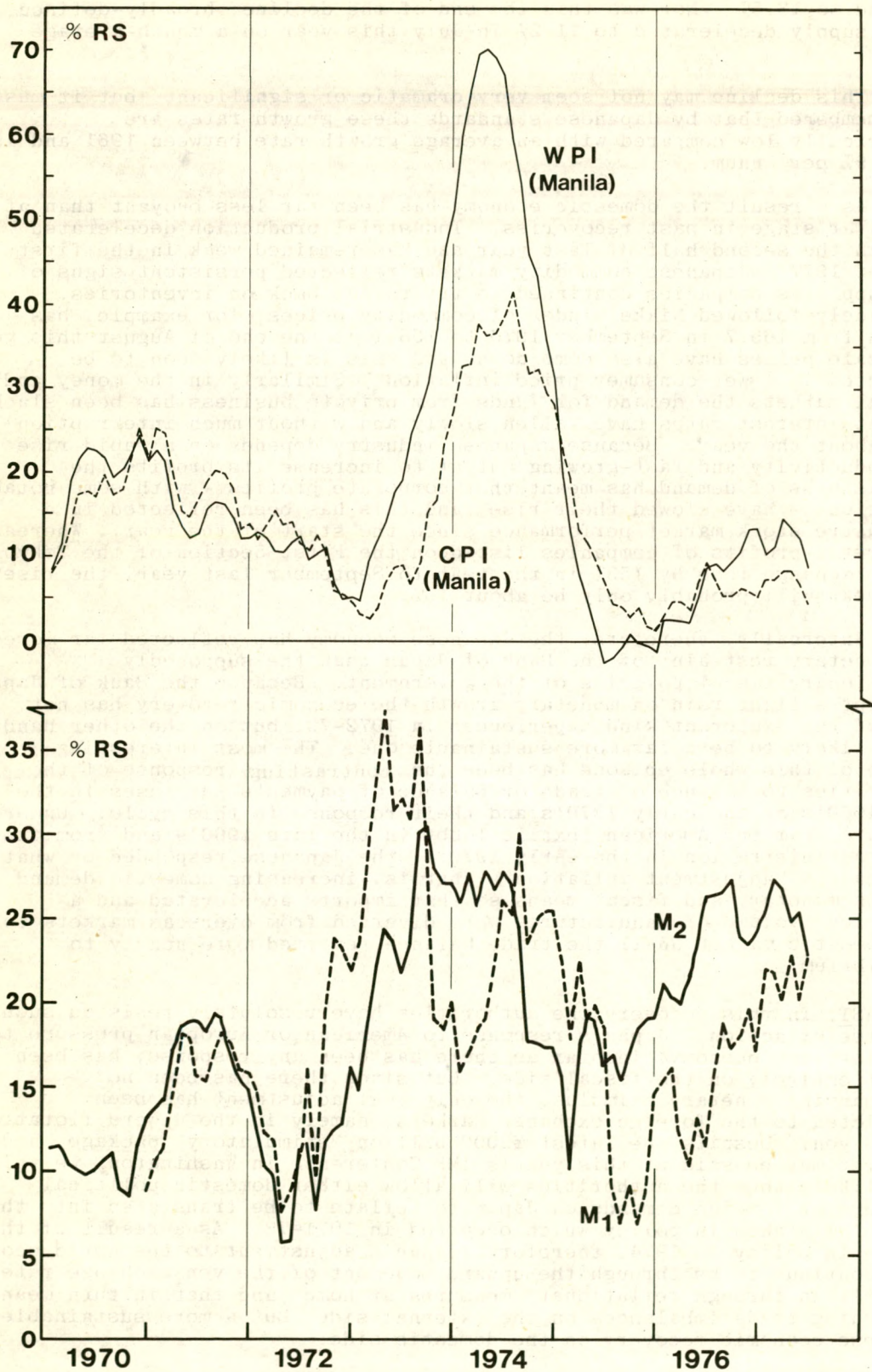
As a result the domestic economy has been far less buoyant than at a similar stage in past recoveries. Industrial production decelerated through the second half of last year and has remained weak in the first half of 1977. Japanese commodity markets reflected persistent signs of oversupply as companies continued to try to cut back on inventories. The widely followed Nikkei index of commodity prices, for example, has fallen from 165.7 in September 1976 to 156.1 at the end of August this year. Wholesale prices have also come down, and this is likely soon to be reflected in lower consumer price inflation. Similarly in the money and capital markets the demand for funds from private business has been slack, so that interest rates have fallen slowly and without much interruption throughout the year. Because Japanese industry depends on a rapid rise in productivity and fast-growing output to increase its profits the sluggishness of demand has meant that corporate profits - with some notable exceptions - have slowed their rise, and this has been reflected in a lacklustre stock market performance since the start of the year. Whereas the pretax profits of companies listed on the First Section of the Tokyo Stock Exchange rose by 153% in the year to September last year, the rise this year will probably only be about 10%.

Internally, therefore, the Japanese economy has reflected far more the monetary restraint of the Bank of Japan than the supposedly expansionary fiscal policies of the government. Because the Bank of Japan has kept a tight rein on monetary growth the economic recovery has not been of the exuberant kind experienced in 1972-73, but on the other hand it is likely to be a far more sustainable one. The most interesting aspect of this whole episode has been the contrasting response of the authorities to balance of trade or balance of payments surpluses in the late-1960's or the early 1970's and their response in this cycle. Under pressure from the American textile lobby in the late 1960's and from the Nixon Administration in the early 1970's, the Japanese responded by what they called "adjustment inflation", that is, increasing domestic demand by both monetary and fiscal means so that imports accelerated and a sufficient volume of manufactures were diverted from overseas markets to the domestic market until the trade balance reverted more nearly to equilibrium.

FORECAST: In this recovery the authorities have resolutely resisted such a course of action. Japan's response to American or European pressure to stimulate the economy, insofar as there has been any response, has been almost entirely on the fiscal side. But since there has been no accompanying monetary stimulus, the only real adjustment has been restricted to the foreign exchange markets, namely in the upward flotation of the yen. Despite the latest ¥2000 billion "stimulatory" package, and whatever may be said at this year's IMF Conference in Washington, we think it unlikely that the authorities will allow either domestic political pressure or foreign demands on Japan to reflate to be translated into the kind of mistakes in policy which occurred in 1971-73. As a result of the switch in policy in 1974, therefore, Japan's adjustment to the world economy will continue to be through the upward movement of the yen exchange rate rather than through reflationary measures at home, and that in turn means continuing trade imbalances on the external side, but a more sustainable Japanese economic recovery on the domestic side.

PHILIPPINES

CHART 4 : MONEY AND PRICES



PHILIPPINES

WILL INFLATION THREATEN THE TRADE BALANCE ?

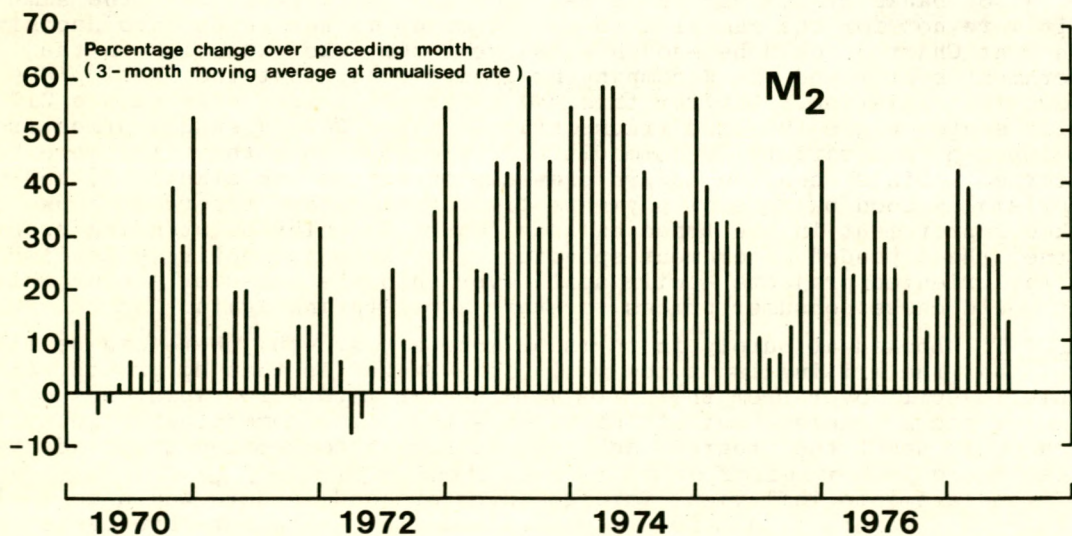
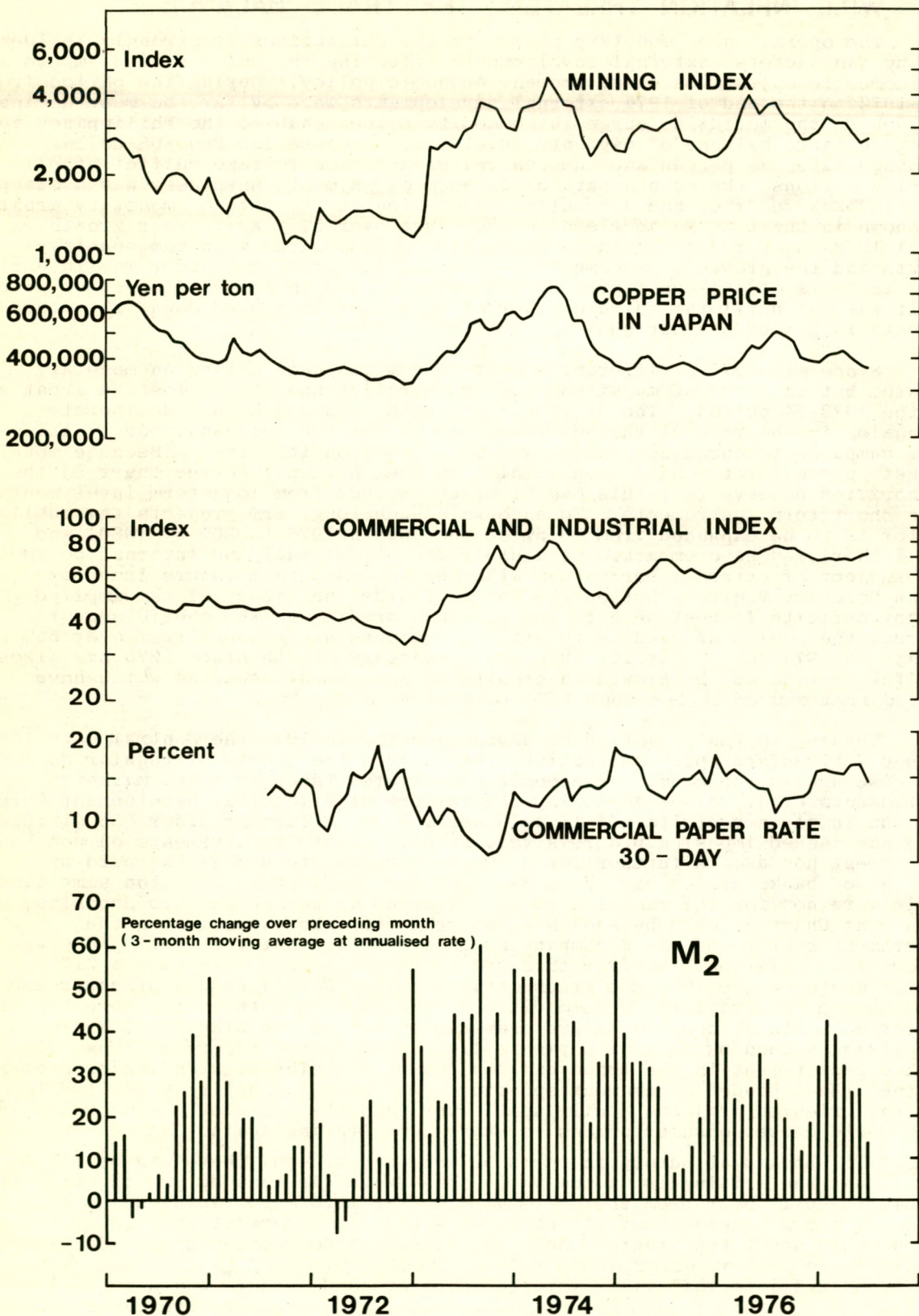
The operation of monetary policy in the Philippines is strongly influenced by two factors: external developments affecting the balance of payments and the domestic objectives of government economic policy. During the period from mid-1972 to the end of 1974 external developments were by far the most dominant influence: the worldwide surge in commodity prices enabled the Philippines to generate large balance of payments surpluses. Because the Peso/US dollar exchange rate was pegged and the Central Bank failed to take sufficient off-setting actions, the counterpart of balance of payments surpluses was a steep rise in bank reserves and a resultant explosion in the rate of monetary growth. As shown in Chart 3, M_2 accelerated from just over 5% year-to-year growth in April 1972 to over 30% growth in Sept. 1973. Associated with the monetary growth and the growth in income from exports, inflation got under way in early 1973 in terms of wholesale prices, and in late 1973 in terms of consumer prices. As it was not until the third quarter of 1974 that M_2 slowed down, the lagged effects in prices did not show up until mid-1974.

Since mid-1975 a different set of forces has been acting on monetary growth, but in terms of magnitude the acceleration has been almost as great as in the 1972-74 period. The driving force this time has been a deliberate expansion in the role of the government sector on the one hand, and a nationwide campaign to encourage the growth of savings on the other. Because money market interest rates have been so high in the Philippines (see Chart 5) the authorities believe that this has diverted savings from long term investment into short term instruments. To encourage such long term projects the public sector is to be expanded from 10.5% of the GNP in 1976 to 20% by 1980, and the authorities have embarked on a programme of external and internal borrowing. The subject of external borrowings will be discussed in a future issue of Asian Monetary Monitor, but on the internal side the impact of the implied budget deficits is best seen in the growth of credits to the public sector. Whereas the growth of credits to private business has slumped from over 50% growth in 1974 to 14% earlier this year, monetary growth since 1975 has almost entirely reflected the growth in credits to government agencies which have soared from P3000m in December 1974 to P8000m in May 1977.

Turning to the promotion of savings, early in 1976 the Central Bank (CB) issued 7 circulars which collectively encouraged the growth of regular deposits and discouraged the growth of deposit substitutes (such as money market instruments etc). Also, following the failure of Filcapital Development Corp. and the insolvency of its affiliate General Bank, a further order (CB Circular 553) was issued imposing progressively higher reserve requirements on non-bank investment houses. A further set of moves designed to double the paid-up capital of banks over a period of 3-4 years was instituted about the same time. If it were not for the campaign to switch money market funds into deposits, a glance at Chart 3 would be enough to suggest that the expansion in the government sector and the accompanying growth meant that the Philippines was headed for inflation. Earlier this year after oil prices were raised 21%, public sector wages 10%, and transportation fares 30%, a sudden price freeze was imposed on a variety of commodities. Clearly the authorities were becoming concerned. Since then the upward pressure on prices has slackened, and some surprisingly good balance of payments figures have been recorded thanks to a marked improvement in the trade balance (Chart 5). The outstanding problem is whether the expanded government spending - which is not entirely devoted to capital-oriented projects - will spill over into the consumer sector which in turn would cause consumer prices to start accelerating again.

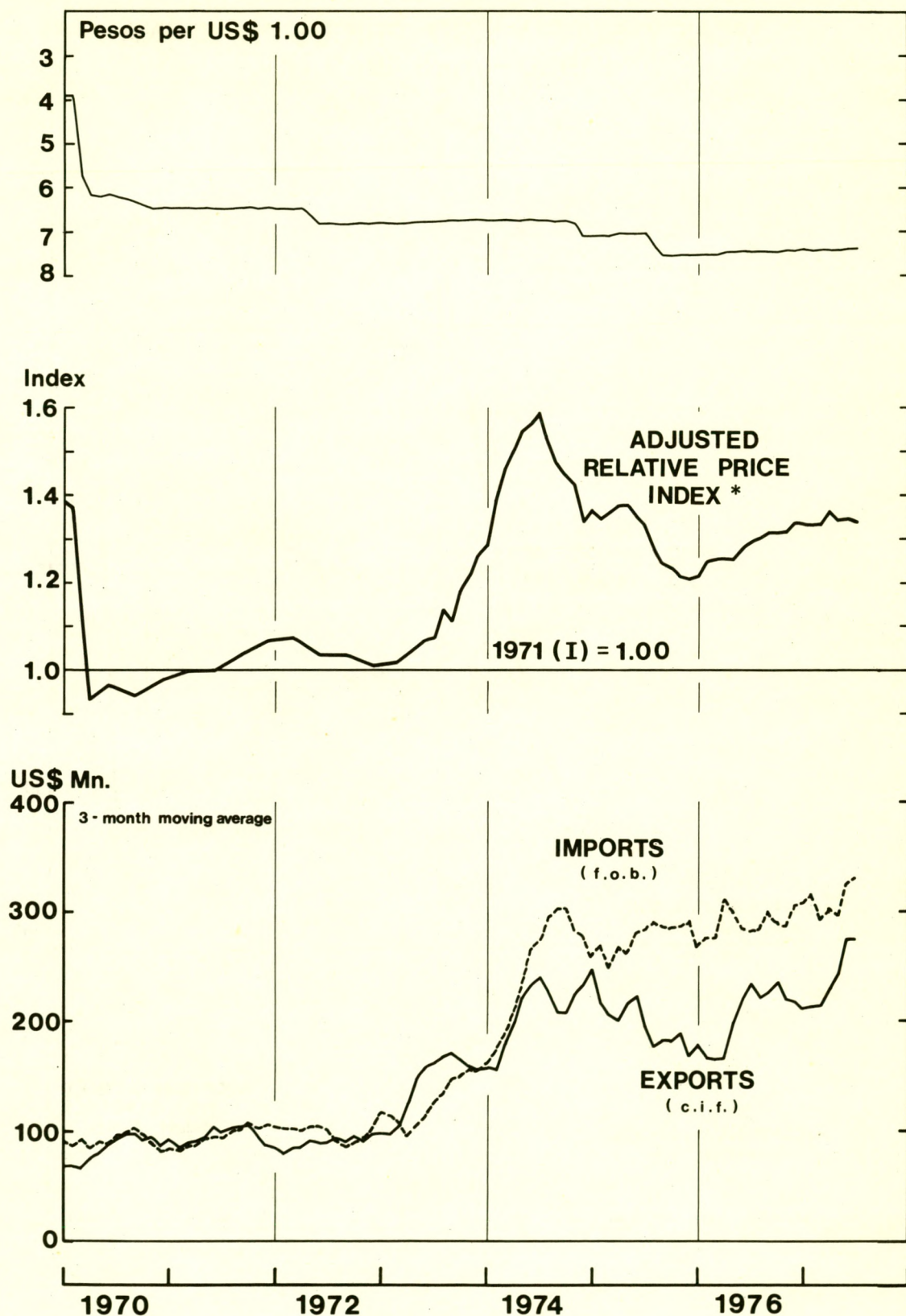
FORECAST: Looked at purely in terms of monetary growth, there can be little doubt that the writing is on the wall: the danger is that M_2 growth rates are liable to spill over from the investment sector into more rapid consumer spending and a renewed bout of inflation - this time domestically generated - which could upset the progress achieved so far in correcting the trade balance. Unless there is convincing evidence that these high money growth rates will not translate into inflation, foreign investors and lenders would do well to anticipate a reversal in monetary policy and tighter rather than easier money which will undoubtedly be necessary if these incipient problems come out into the open.

PHILIPPINES **CHART 5 : THE MONEY MARKET AND STOCK MARKET INDEXES**



PHILIPPINES

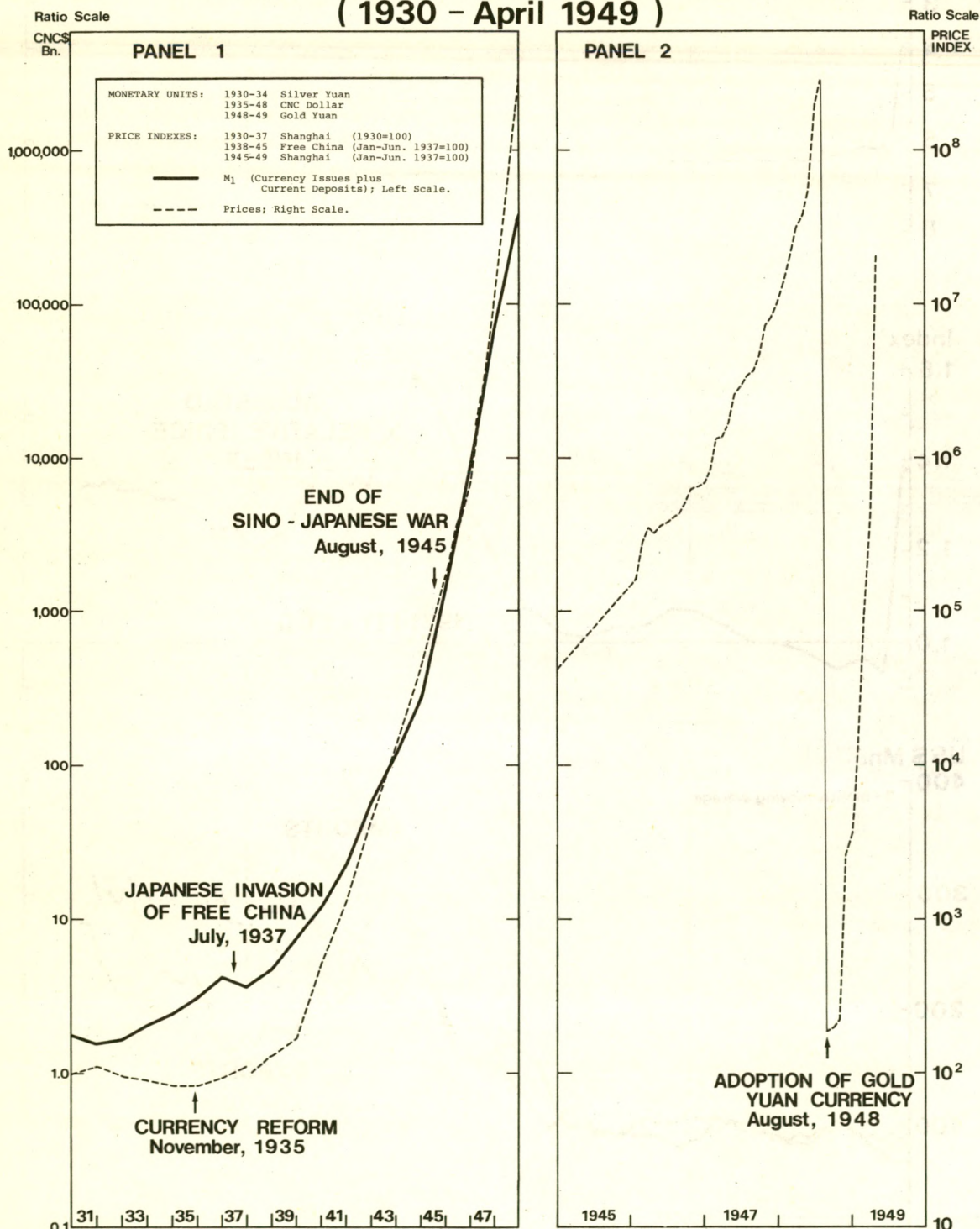
CHART 6 : EXTERNAL TRADE, RELATIVE PRICES AND EXCHANGE RATE



* Philippine prices vs. U.S. prices adjusted for exchange rate changes.

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MONEY SUPPLY AND PRICES IN CHINA (1930 - April 1949)



Source: Chang Kia-NGau, "The Inflationary Spiral"

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EPISODES FROM ASIAN MONETARY HISTORY

THE CHINESE HYPERINFLATION : Part 1

Monetary and Fiscal Origins of the Inflation, 1932 — 45 *

INTRODUCTION

"Inflation anywhere is a means of merciless yet covert exploitation of the working people; it is the worst kind of forced government loan or tax imposed on the people. Devaluation of a currency by half means doubling the price level, ... the money in any person's hands loses half its purchasing power, the other half snatched away by the government that issues the bank notes. This is an exaction which even beggars cannot escape." These sentiments do not flow from the pen of a modern monetarist. Rather, they are found in an official publication of communist China entitled "Why China has no inflation." The writer continues, "It was through such extortions that the reactionary Kuomintang government plundered the wealth of the Chinese people to the tune of 15,000 million silver dollars in twelve years before liberation."

The above quotations highlight a curious feature of China's inflationary spiral. For twelve years China suffered the debilitating effects of accelerating hyperinflation. The Nationalist "Kuomintang" government under Chiang Kai-shek was incapable of solving the basic problem. In part because of the availability of American and British aid, the period is marked by a continued refusal on the part of the authorities to impose self-discipline and rationalise costs. Instead, government expenditure soared skyward to meet the cost of suppressing the Japanese invasion, and later to finance the civil war against the Communists. Yet, the irony is that it was ultimately the breakdown in society caused by the inflation which provided the Communists with their chance to seize power. For through their failure to observe the basic principles of financial prudence the Kuomintang regime alienated the vast masses of the people. It was the subsequent Communist government which restored the authority of centralised government and thus overcame the inflation within a period of two to three years. Moreover, the Communist achievement was the result of a commitment to an unusually strict, classical economic orthodoxy. Budgets were balanced, a commodity standard was enforced, and inflationary note issue prohibited. It is this paradox, along with the length and extent of the inflation, which makes the episode so worthy of note.

The arrival of the Communists in power also represents something of a watershed in Chinese history. Certainly, dynasties had come and gone before. More often than not, their decline was a consequence of financial decadence and inflationary tensions. Yet the Communist success is something more than a mere transition of political power resulting from an economic crisis. It marks a profound break with the old hierarchical Confucian order. From this more long-term historical viewpoint, the Chinese hyperinflation attains still greater significance. Far more than in the German Weimar republic, the result was a fundamental re-ordering of society.

* This analysis is the first in a three-part study. Part 1 deals with the monetary and fiscal origins of the inflation in Republican China and traces the development of the inflation up to 1945. Part 2 will cover the period of most intense inflation from 1945 to 1949, and Part 3 will describe the achievement of price stability in China after 1949 by the Communists. Acknowledgements will be listed after publication of Part 3.

A highly turbulent period, involving revolution, depression and war, preceded the outbreak of hyperinflation in China. In 1911 the unpopular Manchu dynasty fell, and the revolutionary leader, Sun Yat-sen, established the Chinese Republic. Liberally-inclined reformers, highly influenced by western thought, dreamed up constitutional schemes and plans for democratic government. Yet such activity ignored the reality of primitive China. Unlike western Europe, or for that matter her eastern neighbour Japan, China had not experienced industrialisation. Right up until the Manchu's fall, she remained locked in her Confucian past. The imperial hierarchy dominated while for the mass of the people the family was the all-important social unit. Life, in such a strictly ordered universe, revolved around the family and agriculture; the highest object of reverence, the ancestors. Western concepts of individualism, let alone democracy, were completely alien to China at the beginning of this century. The only major exception to this was the student elite, and it was this group which was most active in the 1911 revolution.

The 1911 revolution failed through its inability to recognise China's political immaturity. Despite the nobility of his ideals, Sun Yat-sen, the founder of the Kuomintang, was far too naive for the world of "Realpolitik". Disillusioned and out-manoeuvred by the unscrupulous Yuan Shih-kai, Sun Yat-sen resigned, and Yuan Shih-kai secured power, backed by a loan of £ 25 million from the International Consortium, comprising England, France, America, Germany, Russia and Japan. The Consortium symbolised the extent of foreign interests in China. Since the nineteenth century, and the infamous Opium Wars, China had become a helpless victim of foreign intervention. Loans were advanced for such capital projects as the construction of railways, which underdeveloped China was unable to pay back. Under the Manchus, the imperial government was forced to mortgage a growing proportion of its revenue to service the interest payments on foreign loans, and the loss of revenue accelerated after 1911. Furthermore, the foreign influence had resulted in the establishment of independent territories within China, administered by Europeans, the international concessions. The most important of these was Shanghai, and it was here that commercial and financial activities were concentrated. The interior was neglected and became increasingly impoverished. Economic activity was generally limited to the coastal cities, attracted by the presence of the foreign banks and trading companies.

The rise of Yuan Shih-kai to power marks the start of the warlord era. Until 1927, and then more spasmodically for another ten years with Chiang Kai-shek's growing authority, China's national development was obstructed by a succession of provincial wars. Regionalism predominated, while any concept of national government remained purely nominal. The closest analogy in European history is the age of the medieval baron. This underlines China's immaturity in terms of historical development. It also enhanced the destructive effects of the colonial powers' presence, for the Europeans were quite prepared to play off one faction against another to further their own interests. A noteworthy example is provided by the importing of weapons into China after the First World War. For the west this trade provided a suitable means of profiting out of redundant war material, while for the wretched Chinese peasantry it meant an ever-mounting burden of levies and taxes in kind imposed by powerful warlords, fired by an insatiable need for more arms and more soldiers. Numerous new taxes were thought up by the warlords' lackeys: there was a "circulation of money" tax and a "purification of the countryside" tax. Perhaps the most notorious example is the "laziness tax". Imposed on those who did not grow opium, the idea was to force the peasants to grow opium because of the large profits the landlord could gain from the crop. The tax was even enforced in areas where opium could not be physically planted. Coinage also deteriorated in the disorder. By 1917, the silver coin was alloyed with lead, while the final debacle was the introduction of baked clay coins. Under the warlords, finance was based on opium and arbitrary taxes imposed on the peasantry. In such conditions, meaningful economic development was impossible.

THE RISE OF CHIANG KAI-SHEK AND THE FIRST TEN YEARS OF KUOMINTANG RULE

The damage done by the warlords was recognised in 1924 with the formation of the United Front, signifying co-operation between Sun Yat-sen's Kuomintang and the Chinese Communist Party. The objective behind the alliance was to restore centralised authority in China. In August 1927, the Communists split from the United Front, a division precipitated by Chiang Kai-shek's rise to the top of the Kuomintang, and his increasingly apparent hatred of Communism. His bitter crusade had led in 1927 to mass slaughtering of militant peasants, and was to be evident in subsequent years in Chiang's official programme of "Extermination Campaigns".

In the decade after 1927, until the outbreak of the war with Japan, the Kuomintang under Chiang Kai-shek concentrated on the restoration of a truly national government. The regional powerbases of the warlords were undermined, while by 1934 the Communists were driven back to the north western mountain retreat of Yen-an.

There was therefore a consolidation of the Nationalists' power in the 1930s. Yet this was only part of the story. For on September 18th, 1931, the Japanese occupied Manchuria. This aggression partly reflected a history of Japanese imperial ambitions and partly the growing influence of the militarists within Japan who had risen to power as a result of an economic depression and which had led in the spring of 1927 to 35 Japanese banks closing their doors. The Manchurian action was well timed. In addition to China's own chronic weakness the western world was itself in a slump. In 1929, Wall Street had crashed, while Britain was forced off the gold standard only a few days after the Japanese occupation. The rationale behind the Japanese action was to exploit the comparative weakness of the western powers to assert her own expansionist ambitions in China. The motive was equally applicable in the subsequent Japanese invasion of the rest of China in 1937. Furthermore, the argument was correct. The western powers were far too pre-occupied with their own feuding to devote much attention to events in their former colonial hunting ground in far-off China. Indeed, they saw the outbreak of the Sino-Japanese war as an ideal way of diverting Japanese militarism. It was not until Pearl Harbour that the allies were forced by events to change policy.

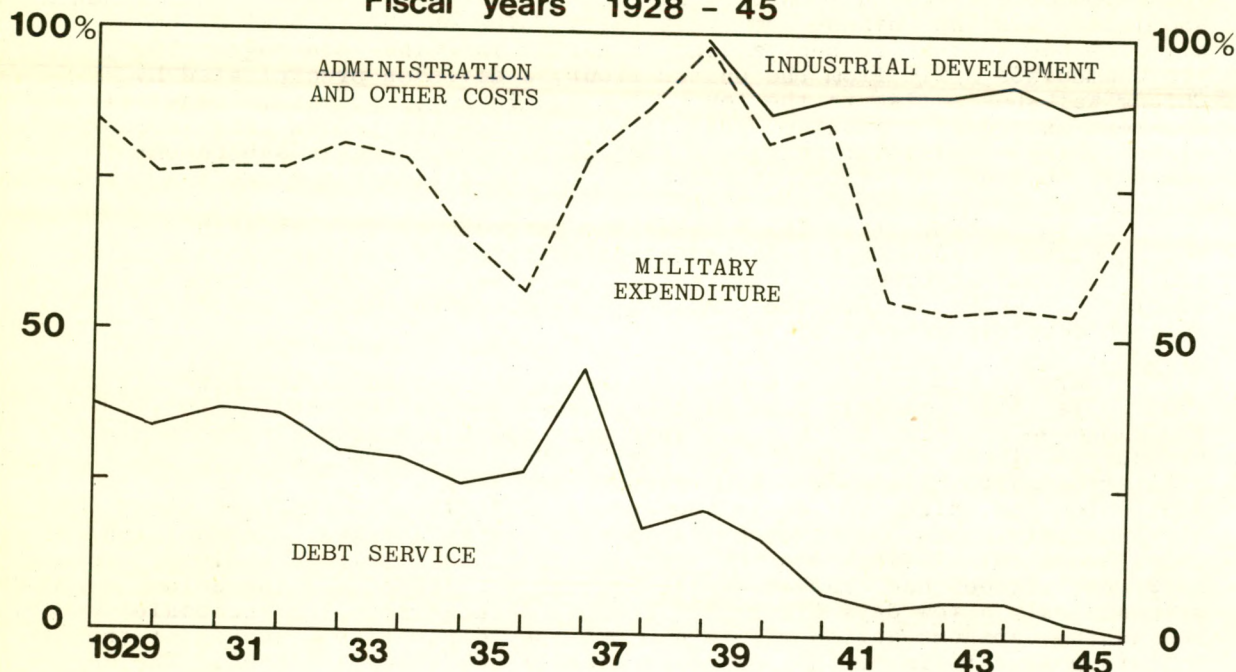
Meanwhile, Chiang Kai-shek's response to the Manchurian occupation was indicative of China's weakness. The reality was accepted, and no resistance offered. The Kuomintang leader concentrated instead on building up his army to meet the inevitable Japanese aggression. A strong army was also required to suppress the Communists and the regional power bases of the remaining warlords. These military demands were a crucial reason for the growing budgetary deficits of the Kuomintang. The debilitating effect of a long background of deficit financing was a prime factor in China's subsequent hyperinflation.

MOUNTING GOVERNMENT DEFICITS IN EARLY KUOMINTANG CHINA

The major reasons for the budget deficits are clear from the chart on Page 28. The vast proportion of expenditure was accounted for by military outlays, and the servicing of old debts. The high levels of military expenditure were partly a result of the political situation, but they also reflected the Kuomintang's own prejudices. When it came to a choice between holding down military spending or seeking further credit, the Nationalist leadership always opted for the latter. For example in 1928 and 1929 disarmament conferences were held in attempts to reduce the two million armed men still under warlord control. But since Chiang Kai-shek was not prepared to make an appropriate concession on his own part, expenditure on armies and armaments continued to mount.

The degree to which government expenditure was committed to servicing the interest on previously contracted debts reflects the history of western intervention in China. Between 1912 and 1926 some 500 million Yuan or Chinese

CENTRAL GOVERNMENT EXPENDITURE (% COMPOSITION) Fiscal years 1928 - 45



National Currency dollars (CNC\$) was borrowed from abroad by the government, in addition to the legacy of CNC\$626 million worth of foreign debt left by the Manchus, and the Boxer indemnity of CNC\$1,870 million. These figures do not take into account the domestic debt. After 1927, the government continued to borrow heavily, and by 1934 the total indebtedness, domestic and foreign, stood at CNC\$2.5 billion, excluding CNC\$200 million in foreign railway debts and unsecured loans. The crushing weight of debt repayments forced the government to mortgage off its own revenue to the creditors, with the result that many vital revenues were collected by foreign interests. Until 1949, the Inspector-General of the Chinese Customs was a foreign national. Meanwhile, the cost of repaying old debt necessitated raising new loans. Throughout the first decade of the Kuomintang rule, military spending and loan servicing together accounted for approximately 80% of total expenditure. Between 1928 and 1935, the annual government deficit had soared from CNC\$80 million to CNC\$383 million.

On the revenue side, the government was heavily dependent on indirect taxation. The most important of these taxes were customs duties, the salt tax, and the tax on commodities such as tobacco, cotton and flour. These levies, with the exception of the customs duties, were highly regressive, since they were charged on necessities. Until 1943, with the success of the Japanese wartime coastal blockade, the customs revenue contributed most to the total revenue. The only form of direct levy was the land tax. Again, this placed the greatest burden on the peasant, especially as the assessment had not been revised since the Manchu era. Many landowners had in any case been able to evade the measures due to changes in ownership since 1911. Between 1928 and 1935, government revenue did rise by 103%, but despite the improvement, the wealth of the country was not really adequately tapped. There was no development of an income tax, although proposals were put forward in 1930. The failure to introduce a progressive form of direct taxation is a symptom of the weakness of both the country and the government. The negative factors were formidable: the administrative costs involved, the

likelihood of local corruption and evasion, the primitive nature of accounts. Even more important, the Kuomintang could not afford to alienate the still powerful provincial authorities. Since this group profited out of the existing tax structure, any comprehensive reform would have risked their loyalty. Instead, more fiscal measures were imposed on the peasantry without any modification or rationalisation of the existing tax structure. New burdens were simply heaped on top of the old.

The appalling state of China's fiscal system was a major reason for her slow economic development. The ramifications reached far beyond the mere fact of a government deficit for any one year. Perhaps most important was the extent to which expenditure was committed in advance to debt-servicing and military costs. This prevented vital capital and industrial investment from taking place. In the absence of such spending, China, with the exception of the foreign-owned factories, remained predominantly agricultural and impoverished. In sharp contrast to Japan, whose leaders had embarked on a policy of frantic industrialisation in the second half of the nineteenth century, China lay entrenched in her medieval past, reliant for her revenue on the miserable squeezing of her peasants. Dr. Han Suyin has put the point clearly: "No strong national bourgeoisie could develop in these circumstances, or find the capital to create independent industries, or found that middle class, both managerial and technical, which developed in Europe, and which would have launched China as a bourgeois, democratic modern state."

The constant need to raise money forced the Kuomintang to resort increasingly to bond issues. The net result was disastrous for future attempts to channel people's savings back into investment in government securities. By 1931, 25 internal loans had been raised to the value of CNC\$1,108 million. However, the government soon found itself in difficulties servicing the issues. Inexperience had led to the coupon being fixed at too high a rate, while the period of maturity was too short. In 1932 the commercial bankers, who were the main subscribers, agreed to a lowering of the interest rate on existing loans, and a longer redemption period. Yet the burden of repayment was still too much for the government. In 1936 a compulsory conversion and consolidation loan was issued to retire the outstanding debt balance of CNC\$1,280 million. Maturities of 12, 13, 18, 21 and 24 years were fixed respectively according to the repayment dates of the old issues.

The 1936 reorganisation resulted in a further setback of public confidence in the domestic bond market. Throughout the first decade of Kuomintang rule, the heaviest subscribers were the commercial banks whose activity in the market is partly explained by the fact that government securities could be used as a reserve against note issue, but even more by the high yields offered, especially if the discount on the purchase price is taken into account. Following the measures of 1936 the decline in bond prices became even more marked, as shown in the table below.

Bond Quotations Before and After the 1936 Reorganisation

6% Consolidation Bonds Secured on Customs Revenue	February 1936 CNC\$	June 1936 CNC\$
Twelve-year bonds	76.46	63.80
Fifteen-year bonds	71.33	61.15
Eighteen-year bonds	64.26	57.75
Twenty-one-year bonds	61.00	57.60
Twenty-four-year bonds	61.00	57.65

The banks' heavy purchasing of domestic debt instruments had severe implications for the economy:

- 1) it allowed the government to postpone the growing need for retrenchment;

- 2) it channelled the liquidity of the banking system into the unproductive government sector, so putting a squeeze on the private sector in the early 1930s.

THE CHINESE BANKING STRUCTURE

At the formation of the Kuomintang government in 1927, commercial banking in China remained at a very primitive level. In the interior, credit was mainly supplied by the native banks, who concentrated on short-term loans in the area they served. There was also the pawnshop, individual money lenders, and the local land owners profiting out of the business of advancing credit. In the larger cities, and predominantly in Shanghai, were the large foreign banks. These provided sophisticated examples of the modern techniques of banking, but their activity also hindered the development of China's own integrated system.

At the beginning of the century, incipient nationalism had led to the establishment of modern Chinese banks, based along foreign lines. Yet the extent of the foreign banks' business, as well as the people's attachment to the old credit structure in the villages, prevented the development of a modern banking system. The most glaring defect was the absence of a central bank. No one authority was responsible for monetary management in the economy. Instead, a multiplicity of note issues circulated simultaneously with the result that one bank's note sold at a discount to another's. Without explicit reserve requirements the dangers of excessive monetary expansion were obvious, but in republican China it was left to the more responsible among the banks to impose on themselves reserve ratios against their own note issue. The defects in the banking system were aggravated by a history of government irresponsibility. Banks were seen essentially as agents for financing the government's debt. Hardly any thought was given to the need for regulating the money market and maintaining public confidence in the currency. The government's attitude is clear from their arbitrary attempts to sequester the deposits held by the private banks. In 1916, such an action had been resisted by the Shanghai branch of the Bank of China, when a government order to suspend the redemption of notes against silver and freeze deposits was ignored. Instead the Bank of China dutifully paid out silver to anxious depositors for several days in succession until the run was over. The success of this stand set a precedent for the independence and integrity of the modern Chinese commercial banks. Yet the ignorance of those in authority of paper currencies is strikingly clear from the continued habit of offering the right of note issue in bargaining for new loans.

In 1928, some advance was made with the establishment of the Central Bank of China. In the same year, the Bank of China had refused the government's request that it become the central bank, despite the likelihood of a monopoly of note issue. The reason is clear. Government ownership would have deprived the Bank of China of its independence to refuse demands for loans. That these demands would have been forthcoming was evident from the deterioration in the national finances. The growing budgetary deficit also explains the failure to secure for the Central Bank the monopoly of note issue in 1928. The government was unable to repay the outstanding debt of the Bank of China and the Bank of Communications - some CNC\$100 million - which the two banks demanded if they were to withdraw their own notes from circulation. The new Central Bank was thus unable to secure sole right of note issue, an essential prerequisite for the centralised control of monetary policy. Instead monetary management remained essentially in the hands of the individual banks, its responsible execution dependent upon the whims of a collection of bankers.



"SILVER CERTIFICATE: This certifies that there is on deposit in the Treasury of the United States of America TEN DOLLARS in silver payable to the bearer on demand."
(Series of 1934C)

In December 1932 the world price of silver reached an all-time low, just over 24 US cents per fine ounce. To stimulate domestic silver production and to secure silver for the U.S. government's bullion reserves, the Silver Purchase Act was enacted by Congress in June 1934, directing the Secretary of the Treasury to buy silver at home or abroad until either the price had risen to US\$1.29 an ounce or silver comprised one quarter of the value of the government's total gold and silver stock. In exchange for the silver it purchased, the Treasury was required to issue silver certificates. These circulated widely, both in the U.S. and in the Far East. The Silver Purchase Act and the issue of silver certificates were to have far-reaching consequences for the monetary and political history of China.

AMERICAN SILVER PURCHASE POLICY AND INTERNAL DEFLATION IN CHINA

If fiscal chaos and a vulnerable banking structure constituted the background to inflationary government financing, the monetary origins of the hyperinflation in China are to be found in the developments which led to China's abandonment of the silver standard in 1935. Because China was on the silver standard, the fall in silver prices after 1925 caused a depreciation in the Chinese silver yuan from an average of 56.9 US cents in 1925 to 41.9 cents in 1929 and 21.7 cents in 1932. The resulting inflow of cheap silver into China produced an expansion in bank reserves and contributed to a mild inflationary boom from 1926, a boom which continued for two years after the start of the worldwide depression in 1929. The fall in silver prices amounted in effect to a devaluation of China's currency just at the moment when the major industrial economies were entering the great depression, and the resulting inflow of cheap silver enabled the Chinese economy to remain reasonably buoyant. The silver standard therefore acted like a flexible exchange rate, initially insulating China to a large extent from the depression affecting those countries on the (fixed exchange rate) gold standard.

But in the following years the picture was reversed. The major reason was the American programme of large-scale buying of silver. To stimulate domestic silver production and to secure silver for the U.S. government's bullion reserves, the U.S. authorities announced in July 1933 that they would accept repayment of debts in silver as well as gold, and in June 1934 Congress passed the Silver Purchase Act, directing the Secretary of the Treasury to buy silver on world markets (see inset box above). The results of the policy for China were grim.

In the face of American purchases of approximately 1,600 million ounces between 1934 and 1937 the value of the Chinese silver yuan began to appreciate, doubling from an average of 19.5 US cents at its lowest in December 1932 to 41.1 cents in May 1935. As the price of silver rose businessmen and dealers demanded redemption of Chinese paper currency to obtain silver for export. The withdrawals depleted Chinese bank reserves. Money became scarce, credit tightened, prices fell, banks and other businesses failed, and trade in the interior stagnated.

The accelerating price of silver caused a flood of silver from the interior into Shanghai. Initially, there was a period of pseudo-prosperity because the accumulation of silver in Shanghai resulted in a growth in bank deposits there, and in turn a credit expansion, which led to a bull market in government securities and a boom in real estate. The "boom" was short-lived. For as the silver price continued to soar, silver flowed out of the country, along with the funds of foreigners who had been postponing remittances, correctly anticipating a more favourable exchange rate.

The sudden outflow of funds caused a severe credit squeeze, especially in Shanghai, where the banks had only recently been indulging in credit expansion. Loans were called in, extra collateral demanded while interest rates jumped. These symptoms of tight money reflected the deflation within China. Because of China's silver standard, the demand for the metal went hand in hand with a marked appreciation of the currency. Imports declined while exports became increasingly uncompetitive. Industrial production drew to a halt with the low level of activity in the economy, unemployment rose, and prices slumped. The effect of the deflation on agriculture is clear from the fall of the price index of agricultural produce from 100 in 1926 to 57 in 1933. This represented an appalling decline in income, and hence purchasing power, for those living by cultivation of the land. Once again the Chinese economy was moving in the opposite direction to that of western economies. The contrast in price trends between China and Great Britain and America are shown in the table below. In 1929-31, China's prices rose while the west suffered depression. In the later period, China experienced deflation as prices climbed in America and Great Britain.

	<u>WHOLESALE PRICE INDICES (1935 = 100)</u>			<u>EXCHANGE RATE</u>
	<u>U.S.</u>	<u>U.K.</u>	<u>China (Shanghai)</u>	<u>Sterling per Unit Yuan Index</u>
1930	109	112	120	67
1931	85	99	132	68
1932	71	96	118	81
1933	74	96	108	81
1934	89	99	101	92
1935	100	100	100	100
1936	102	105	112	82
1937	108	122	124	82
1938	100	112	159	60

ABANDONMENT OF THE SILVER STANDARD

The catastrophe of deflation in China was therefore the direct result of American policy. The silver purchase programme also provoked the currency reform in China of 1935 and it was this reform which laid the groundwork for the later monetary explosion. The currency reform moved China from the enforced disciplines of the silver standard to a managed currency, commonly known as the "fapi" (法幣, i.e. "legal tender"), not based on any metal. Consequently, a radical reform of China's monetary system was desperately needed if China was to avoid unlimited monetary expansion. W.Y. Lin in his book "The New Monetary System of China" written in 1936, saw the issue clearly : "A simple and automatic mechanism is replaced by a complex and discretionary management a sound



Banknotes issued by three out of the four approved issuing banks after the Currency Reform of 1935. These banks were increasingly to lose their independence as the Kuomintang government extended its control over the main levers of the economy. The banks, with their ability to extend credit to the government, were the first targets in this process. In 1942, the escalating demand for money required the shipment by air of 150 tons of paper money into China over the Himalayas ("The Hump").

effective management of currency requires a perfection of the financial mechanism and a centralisation of financial control. The central authorities must be independent enough to resist the irresponsible demands of government borrowings, and powerful and competent enough to exercise the desired control over the money market through a discount policy and open market operations."

The currency reform did contain some of the required changes. By 1936, the right of note issue was limited to four banks : the Central Bank, the Bank of China, the Bank of Communications and the Farmers' Bank. Other planned reforms were that reserve deposits of the commercial banks were to be held at the Central Bank; that the Central Bank would be responsible for monetary policy, independent of the spending demands of the Treasury; and that the government would not hold more than 40% of the Central Bank's capital stock. These reforms were not implemented due to the outbreak of war with Japan and the complete paralysis of government will. This was a disaster for the future of price stability in China. Furthermore, the commercial banks' confidence in the responsibility of the government was not helped by the arbitrary actions of March 1935, when the State grabbed a controlling interest in the Bank of China and the Bank of Communications in what amounted to naked confiscation. The private shareholders were compelled to issue a number of new shares, which the government then purchased with a promissory note.

Confidence amongst the financial community in the new currency was also not enhanced by the Kuomintang's determination to maintain the exchange rate at a fixed level, as if this was some symbol of national strength. W.Y. Lin again provides a penetrating contemporary judgement : "In the U.K. and U.S.A., the management of the currency has as its main objective

the stability of internal prices. In the case of our experiment ... it seems probable that the stability of the exchange is given paramount consideration, making our monetary standard more akin to a managed foreign exchange standard ... It should be emphasised that exchange stability cannot be long maintained unless there is a reasonable degree of price stability." These words proved highly prophetic.

The whole episode of the American silver buying programme, the deflation within China and the subsequent currency reform is vital to an understanding of China's later inflation. "The silver programme is a dramatic illustration of how a course of action, undertaken by one country for domestic reasons and relatively unimportant for that country, can yet have far-reaching consequences for other countries if it affects a monetary medium of those countries ... The deflationary pressure and disturbances also did not contribute to the political stability of China. Much of the limited stock of political capacity had to be devoted first to unsuccessful attempts to prevent the export of silver, then to the sweeping monetary 'reform' of 1935. Furthermore, by converting China from a commodity standard effectively to a paper standard, the so-called reform rendered it both easier and more tempting to finance later war expenditures by inflationary currency issues." (Milton Friedman and A.J. Schwartz, : "A Monetary History of the United States").

THE SINO-JAPANESE WAR AND ITS INFLATIONARY IMPACT

The Japanese invaded China proper in the summer of 1937. The occupation lasted for eight years, large parts of the country being occupied, of which the most critical were the productive coastal areas of the north east. Despite blatant Japanese aggression, the Kuomintang government received no military aid from America right down to December 1941, and the bombing of Pearl Harbour. Indeed, the Americans continued to supply Japan with a large proportion of her military materials during the first four years of the Sino-Japanese war. Likewise, until 1941, the Soviets were Chiang Kai-shek's major suppliers. Interestingly, the soviet mission in Chungking, the Nationalists' wartime capital, had no dealings with the Chinese Communists, a significant point in view of Mao Tse-tung's subsequent attitude towards the USSR. In the harsh world of international politics, the allies saw China as a suitable target for diverting Japanese militarism. It was not until after 1941 that the allies turned their attention to defeating Japan, a fact symbolised by the arrival of the American General Stilwell in Chungking.

Within China itself, the United Front between the Kuomintang and the Communists was recreated in 1936. Yet this was purely nominal. In the words of the historian John Fairbank, "The United Front continued only as a facade of national unity, to paper over the fact that the two armed party dictatorships were still rivals for ultimate power." Throughout the Sino-Japanese war therefore, the Chinese operated on what were essentially two different fronts. The Nationalists withdrew to Chungking in the interior, and campaigned on the war front, backed in the later years by the American presence. The Communists operated from their base in Yen-an. Their guerilla activity from behind the Japanese lines provided the opportunity for Mao Tse-tung to mobilise the peasantry into an organised fighting unit, the People's Army. Thus China remained deeply divided within despite the external attack from without.

A succession of Japanese victories marked the early years of the war. By the end of 1937, the Japanese controlled an area extending from Suiyan province in the north to Chekiang on the coast. The port of Shanghai, China's financial and commercial centre, was cut off from the rest of the country. In 1938, the Japanese concentrated on two main strategies. A western advance along the Yangtze with the aim of dividing north and south was combined with a coastal blockade. The success of both policies is shown by the seizure of Hankow and Canton in October. In 1939 a new offensive was launched from the south, with the aim of disrupting China's links with Indo-China. In November, Nanning in Kuangsi was taken, while

in the following year an agreement was concluded with the French Vichy government enabling Japanese troops to direct attacks on the southern provinces from Indo-China. The final achievements of the Japanese expansion were the occupation of Shanghai shortly after Pearl Harbour, and the invasion of Yunnan in May 1942, which severed China's remaining link with Burma.

In the middle years of the war, the Japanese concentrated on a policy of containment. The goal was to isolate the Chinese government through territorial control and coastal blockades. The real turnabout in the conflict did not come until the arrival of American forces. In the middle of 1944 a major offensive was launched, and a succession of allied victories followed. In January 1945, Wanting on the Burma border was taken and the Burma Road re-opened.

Financing a war is at the best of times inflationary. In the Chinese case the inflation was aggravated by the extent and effects of the Japanese occupation. On the supply side, production declined due to the loss of the more industrially advanced areas, centred around Shanghai. Manufactured products were especially affected. By the end of 1938, Japan occupied a third of China. This area accounted for 40% of total agricultural output and 92% of industrial capacity. The Japanese coastal blockade further increased China's isolation. "Free" China's links were severed, not only with the eastern coastal cities, but also with Burma to the west and Indo-China to the south. This was despite the effect of counter-blockade measures instigated by the Nationalist government in a worthy attempt to alleviate some of the damage. The Burma Road was built by a force of 160,000 and opened in 1943, while there were plans for a railway running from Hunan Province, through Kwangsi, to Chennankuan, the terminal of the Indo-Chinese railway. Both these projects had been prompted by the successful Japanese occupation, which had led to such important communication links as the Hankow-Canton railway being lost to enemy control. Both were thwarted by subsequent Japanese expansion.

One consequence of the occupation was that the development of industrial production was desperately required in the more primitive internal areas when the nationalist government moved to Chungking. Previously this region had been dominated by agriculture and was largely self-sufficient. The necessary infrastructure for the needs of war production and the development of markets was absent. The result was rapidly escalating import prices as demand rose and overland supply became increasingly limited. In contrast, locally produced goods did not suffer such pressures initially on account of a series of good harvests in Szechuan. The divergent price patterns are shown in the table below.

Indices of Wholesale Prices in Free China

(January-June 1937 = 100)

	Locally Produced Goods (Chungking)	Goods from Other Provinces (Chungking)	Imported Goods (Chungking)	All Commodities (All of Free China)
December 1937	93	125	147	109
June 1938	95	195	227	127
December 1938	115	275	389	155
June 1939	141	313	501	205
December 1939	221	578	1,054	306

On the demand side, the government was faced by an influx of some 50 million refugees. By 1940 the population of Free China had risen by 40% as a result of the Japanese invasion. It was this interaction of a simultaneous increase in demand with a drastic fall of 50%-55% in Free China's industrial output that sparked off the initial burst of really serious inflation from 1938 to 1939.

THE DEVELOPMENT OF INFLATION DURING THE WAR

The Chinese government's overwhelming priority lay in meeting the demands of war. No sustained effort was made to distinguish between necessary and unnecessary costs, whilst very little attention was given to the country's ability to afford such a commitment, despite the dramatic decline in the country's productive potential occasioned by the occupation. Chang Kia-ngau, a director of the Bank of China in the pre-war years, hints at the almost complete lack of realism inherent in Kuomintang attitudes : "The government leaders were swayed by a combination of traditional Chinese beliefs and modern authoritarian ideas : 'where there is land, there is money,' and 'where there is absolute power, there are goods.' " ("The Inflationary Spiral")

The mounting budget deficit and the accompanying rise in the note issue are shown in the table below :

Government Expenditure and Revenue, 1936-1945

(CNC\$ millions)

<u>Year</u>	<u>Expenditure</u>	<u>Revenue</u>	<u>Deficit (Surplus)</u>	<u>Note Issue</u>
1936-37	1,894	1,972	(78)	
1937-38	2,091	815	1,276	
1938 (July-Dec.)	1,169	315	854	2,310(Annual)
1939	2,797	740	2,057	4,290
1940	5,288	1,325	3,963	7,870
1941	10,003	1,310	8,693	15,100
1942	24,511	5,630	18,881	34,400
1943	58,816	20,403	38,413	75,400
1944	171,689	38,503	133,186	189,500
1945	2,348,085	1,241,389	1,106,696	1,031,900

The effect of the deficits would have been less serious if the excessive expenditure had been met by cash raised from bond issues sold to the public, sales of gold, or some other such non-inflationary source. However, the deficit was financed increasingly through monetary expansion, and the result was accelerating inflation :

- Between July 1937 and late 1939 : prices rose at an average rate of 40-50% a year.
- In 1939-41 declining confidence in the currency was reflected in annual price rises of 160%.
- From Pearl Harbour to 1945 annual price rises accelerated to more than 300%.

The growth in the money supply, prompted by the government deficit, was aggravated by several factors :

- i) The Central Bank of China was not independent of the Finance Ministry - political considerations prevailed over financial orthodoxy.
- ii) The lack of centralised control over the banking system. At the start of the war, the government adopted a policy of liberal credit to facilitate the development of the banking structure in the interior, and encourage industrial production. Instead, the availability of cheap money was used by private and native banks to increase profits in speculative ventures, and only a marginal rise in real output occurred. In sharp contrast to the centrally planned Japanese banking structure, it was impossible for the Chinese authorities to control the allocation of credit.
- iii) The appalling failure of government bond issues. Partly the result of the lack of a developed bond market, but more

because of the growing mistrust of the currency, successive issues flopped disastrously, leaving the Central Bank of China as the residual purchaser and in effect requiring a direct supply of new note issues to finance the soaring government commitments.

1937 - Issue of National Liberty Bonds of CNC\$400 million. After pleading, and appeals to patriotism, just half the issue was taken up.

1938 - Two large issues of more than CNC\$1,400 million yielded proceeds of just 4% of the total issue.

1941 - A Wartime National Bonds Subscription Commission was set up under Chiang Kai-shek himself. Yet despite active promotion, only 5% of the total bond issue was successfully placed.

1942 - A new policy was developed involving the compulsory allocation of bonds based on an assessment of property and income. However, the practical difficulties of means testing proved beyond the administrative capabilities of both central and local governments, and the municipal authorities found themselves filling the quotas demanded by the policy from their own funds. Hence, the money raised by the compulsory issues often originated from existing local government revenue rather than previously untouched sources of private wealth.

- iv) The decline in long term savings deposits. Despite a series of government-sponsored savings campaigns ("Thrift and Reconstruction Savings Deposits Scheme"), as inflation accelerated and deposits lost their value people reduced their holdings of deposits relative to currency. Whereas in 1935 an average of CNC\$2.68 was held on deposit for every unit in circulation, in the five years to 1940 this had fallen to CNC\$0.55. The expulsion of the Japanese in 1945 restored some confidence in deposits, but the respite was only temporary. The same phenomenon was to repeat itself again between 1946 and mid-1948.
- v) The existence of puppet currencies in occupied China. Wherever they went the Japanese introduced their own military note issues, convertible into yen, in direct competition with the Chinese currency. Meanwhile, they sold all the CNC\$s they could obtain on the Shanghai foreign exchange market, further depressing the exchange rate and driving up the foreign exchange cost of imports for the Chinese in Free China.

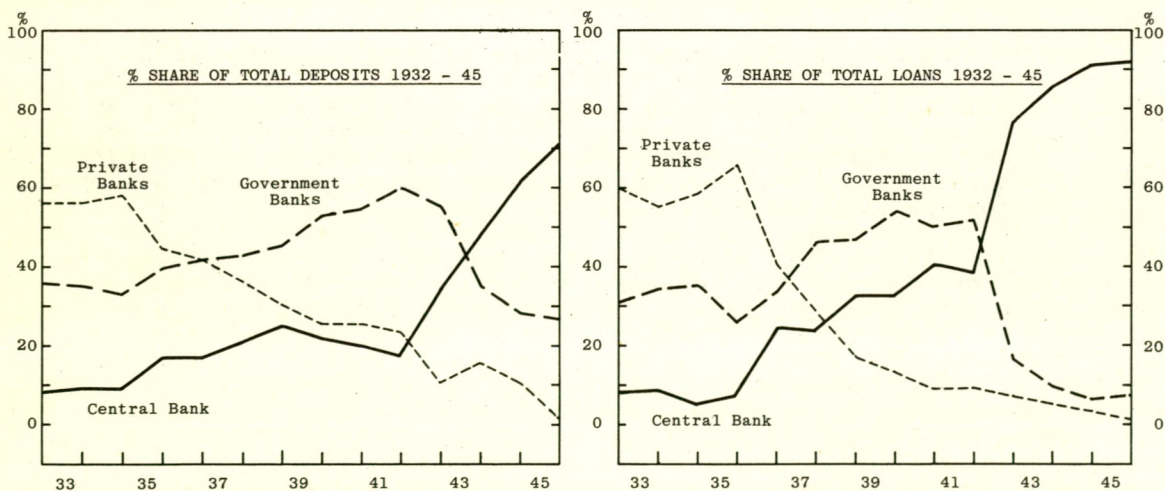
Despite the monetary disorder the government remained committed to high levels of spending. No concerted effort was made at rationalising costs. The army doubled in size, from some 2 million to 5 million, when a smaller, more efficient and better supplied unit would have been far more effective. The absurdity of such a policy is stressed by Chiang Kia-ngau: "There was an element of futility in the government's policy of strengthening the army by numerical increase alone. With the increase in size went a decline in efficiency ... The very magnitude of the army was an almost insuperable obstacle to its operational efficiency." The numbers in the public service also increased: the pre-war level of 3,000 had risen to a staggering 200,000 by March, 1945. Consequently, more and more people were involved in administering unenforceable policies such as price and credit controls at a time when the country urgently required greater productivity.

Until 1939, the growth in the money supply was only partly reflected in the price statistics. The lag in effect owed much to the predominance of the rural sector which was less responsive to pressures in demand, both because of its relative self-sufficiency and its distance from the coast

which hindered the inflow of consumer goods. Also, the uncertainty generated by the outbreak of war had led initially to the hoarding of cash, or a decline in velocity. A certain element of patriotism acted as a further restraint on consumption, delaying the impact of the monetary explosion. Subsequently as government note issues snowballed and commodity prices rose, the hoarding of money gave way to the hoarding of goods, a decline in the value of cash holdings, and an inexorable acceleration in the velocity of circulation.

From 1939 on, inflation began to take off. By October, 1941, "paper currency, printed in England, came in by the ton over the Burma Road, ... Later it was to be flown over the Himalayas, when the Burma Road fell in May 1942." (Dr. Han Suyin: "Birdless Summer"). Further strains on the supply side appeared with the declining trend in food production in the early 1940s and further Japanese advances. One positive development was the collection of land tax in kind from 1942. This ensured that the army was fed, whilst enabling the government to avoid the cost of escalating prices in the market place. However, there was a corresponding rise in prices for other consumers with the decrease in food supplies.

In 1942, the government was precipitated into action by the growing inflation. The result was price and credit controls. These merely attacked the symptoms rather than the cause of the problem, namely the excess of government expenditure over revenue. The administration was quite unable to enforce either measure adequately. Price controls merely resulted in supply shortages and thriving black markets, commodity hoarding and speculation becoming increasingly prevalent. Credit controls, which included the stipulation, dating back to August 1940, that commercial banks hold reserves amounting to 20% of their total deposits in one of the government banks, were successful in reducing the number of loans made to the public. But this was relatively insignificant, when set against the amount of private banks' funds diverted into speculation, and the degree of credit granted the government to finance the budgetary deficit. In 1945, bank advances to the government jumped 7.8 times more than the rise in private credit. Controls on private banks were thus worthless if no corresponding discipline was enforced on the government.



The two charts above illustrate the shifting patterns of activity within the banking system. At the beginning of the period, the loans and deposits of the private banks were at a relatively high level, reflecting both the growth in the economy from 1929-31, when China's silver standard protected her from the depression in the west, and the brief period of pseudo-prosperity when silver flowed into Shanghai in anticipation of foreign purchasing demand. From 1935 on, with the Currency Reform, and the right of note issue limited to the four government banks, the share of these issuing banks in total banking business climbed. In 1942, the granting of sole monopoly of issue to the Central Bank of China sparked off a further rise in its loans and deposits, while the activity of the other government banks subsequently declined. The vast proportion of the Central Bank's loans were advances to meet the growing deficit of central government. Throughout the period up to the end of the war, the share of private banks declined. Their business was not helped by a number of controls on private bank lending.

Throughout the period, exchange rate policy was a crucial part of government strategy. For with the move off the silver standard, the Kuomintang leaders considered the maintenance of a fixed exchange rate crucial if confidence was to be retained in the new currency, especially since Chinese history reveals a long-standing distrust of paper money amongst her people. Consequently, foreign exchange was sold to defend the fixed rate, causing a heavy drainage of foreign reserves, which accelerated as confidence deteriorated and prices rose. In March, 1938 the foreign banks within China ceased observing the fixed rate. These now provided a convenient source for foreign exchange, despite the higher price, as government measures further distorted the market. Meanwhile, the continued erosion of the value of the CNC\$ reduced the Chinese foreign exchange reserves to a minimum level. A temporary saviour appeared in the form of foreign aid.

In March 1937, the Sino-British Stabilisation Fund was established operating in both the Shanghai and Hong Kong markets, but the resources of the fund proved inadequate to stem the tide and the ever-increasing demand for foreign exchange within China led to two temporary suspensions of operations in June, 1937. For a time, the pressure was eased by the outbreak of war in Europe when sterling depreciated against the CNC\$. This allowed for the Fund's continued survival until April 1941, by which time its foreign exchange reserves were exhausted. In the same month the Americans joined the attempt to preserve the stability of the CNC\$ with the creation of the Sino-American British Stabilisation Fund. However, no fundamental change had occurred. The reserves would be continually run down, so long as the government financed the deficit through monetary expansion. Such actions only stimulated the internal inflation and devalued the domestic currency, so increasing the value of foreign currencies in the eyes of the public. International concern was again expressed by the collective action of July 1941 when America, Great Britain and Holland announced the freezing of Chinese and Japanese funds within their boundaries in an attempt to stop speculative movements of capital.

By August 1942 the foreign exchange market was suspended with the Japanese occupation of Shanghai. Any further development in foreign exchange dealing was prevented by the complete isolation of China caused by the Japanese war strategy. But by the spring of 1943, the swelling number of American troops in China had stimulated the growth of a black market in US dollars, so adding further instability to the value of the CNC\$ as people eagerly purchased the foreign currency.

Throughout the wartime period, the adherence to a fixed exchange rate merely concealed the true impact of inflation from the authorities whilst encouraging speculation in goods. It also antagonised the Americans, who objected to providing aid during the war at a vastly over-valued exchange rate. A floating rate would at least have given an indication of market sentiment, and diverted speculation into money as opposed to goods. It would also have meant that the government was faced directly with the consequences of its monetary expansion and the subsequent price rises.

The stubborn attachment to a fixed exchange rate is indicative of the Nationalists' whole approach to economic policy. Throughout the war, finance was at best a secondary problem, subordinate to the Kuomintang's aspirations for national glory. Yet such glory was an illusory dream without the application of sound economics, which took into account China's appalling poverty and her underdeveloped status. Indeed the government's perpetual resort to misguided short-term expedients merely aggravated these conditions until, in the immediate post-war years, they would ultimately engulf China in an abyss of unprecedented national demoralisation, a turmoil of political intrigue and financial chicanery which only served in the end to fertilise the ground for the communist victory in 1949.

(to be continued in Part 2: The Crisis of Hyperinflation, 1945-1949)

NEW BOOKS

"JAPANESE CORPORATE FINANCE, 1977-80"

A Business Study by International Business Information Inc.
Published by the Financial Times, 1977

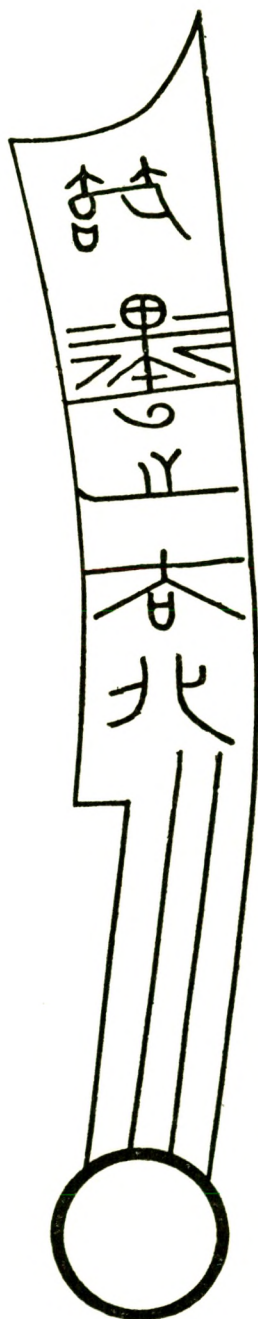
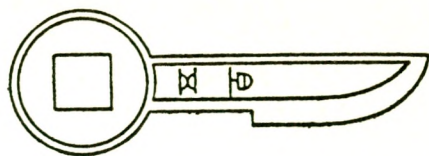
One of the pervasive characteristics of the Japanese financial system is its proclivity towards compartmentalisation. Beginning with the overhaul of the financial system in the middle years of the Meiji era when different types of financial institutions were established for specific purposes, a variety of rigidities were legislated into financial markets. In the interwar years and during the Second World War increasing centralisation of the economy served to harden the financial arteries, a process which was not significantly reversed by the reforms of the postwar Occupation. Despite subsequent attempts to liberalise the system, the forces of central control, bureaucracy, and the status quo have usually combined to obstruct the free interplay of supply and demand. Thus any study of potential future developments in Japanese finance must pay particular attention to the existing institutional framework.

The strength of the new study by Dr. C. Tait Ratcliffe and his assistants at IBI Inc. is that the peculiarities of Japanese corporate finance are explained as the logical outcome of a range of institutionalised incentives. The financial behaviour of Japanese firms - low equity ratios, preference for debt-financing, etc. - is explained as partly deliberate strategy, and partly the result of the structure of Japan's flow of funds. The study is careful to point out the complications involved in measuring equity and debt levels given the conventions of Japanese accounting, and having done so it proceeds to provide the background and rationale for the apparently high leverage of Japanese firms.

A dichotomy running through the study is that as Japanese industries develop, the more capital-intensive tend to grow more oligopolistic. As the number of competing firms diminishes the dominant companies tend to become stronger in financial terms, more independent of their banks, and conforming less to the standard pattern of high debt and low equity ratios. It is not always easy to generalise, but one of the striking findings in the food industry, for example, is that "companies with a strong market position in one or more fields and sound diversification strategies have actually experienced an improvement in their financial ratios as growth has increased." Anybody who read the article by James Abegglen in the Asian Wall Street Journal (Foreign Firms and Japan's Economy, February 2, 1977) will already be familiar with this finding, but Dr. Ratcliffe's study contains a useful industry-by-industry application of the analysis. The pages on the shipbuilding industry and the trading companies are particularly commendable.

The problems of compartmentalisation as they apply to individual asset choice, the interest rate structure, the banking sector, and the development of the Japanese equity and bond markets are explored, and the study reaches generally pessimistic conclusions about the ability of the Japanese financial system to liberalise internally. As a practical example of how difficult it is to forecast developments in Japan a forecast by the Ministry of Finance in 1968 is quoted to the effect that by 1975 the stockholders' equity ratio would rise from 20% to 25%. In fact the ratio declined mainly due to a heavy programme of debt-financed investment designed to meet the threat of foreign competition following capital liberalisation, and because the best protection against takeover was to reduce the 'free float' rather than increase it. Since the Japanese corporate financial scene is subject to the influence of an exceptionally dynamic economy, it will be surprising if all of the predictions in Dr. Ratcliffe's study materialise, but that should not detract from the value of the extremely useful background material contained in "Japanese Corporate Finance, 1977-80".

In ancient China the earliest known media of exchange were not coins, but replicas of such useful articles as knives, hoes, spades or shirts which were traded in place of the real object. Knife coins or bronze "tao" (below left) were in circulation as early as 700 BC.



Since real knives were hung from a cord at the belt or wrist, the knife replica also reproduced the hole at the tip of the handle. Gradually the blade part of the "tao" was reduced until around the 1st century BC the knife looked more like a key (above) than a knife. Eventually only the round handle with its square hole called "cash" (from the Tamil Kas) and representing the value of the original knife survived. Once established these coins continued without much change for two thousand years. The horizontal inscriptions usually mean "precious coin" while the vertical characters refer to the name of an emperor or dynasty.

ASIAN MONETARY MONITOR





ASIAN MONETARY MONITOR

is published by
Asian Monetary Monitor Ltd.,
P.O. Box 20724, Causeway Bay,
Hong Kong.

ASIAN MONETARY MONITOR

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ASIAN MONETARY
HISTORY:** THE CHINESE HYPERINFLATION (PART 2)

Vol. 1 No. 2
November-December 1977

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Asian Monetary Monitor is a bimonthly publication specialising in the analysis of economies along the Asian Pacific Rim. Sold by subscription only, price HK\$500 or US\$100 p.a. inclusive of air mail delivery to any part of the world. Correspondence and subscriptions should be addressed to The Editor, Asian Monetary Monitor Ltd., P. O. Box 20724, Causeway Bay, Hong Kong.

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Asian Monetary Monitor is published in

association with the  group of companies

ASIAN MONETARY MONITOR

Vol. 1 No. 2

November-December 1977

INTRODUCTION

Recent months have seen dramatic movements in exchange rates, divergent trends in interest rates and an increasingly uncertain outlook for international trade. Growing protectionist sentiments in America and Europe, and the accusations and counter-accusations about 'unfair' trading all serve to obscure the fundamental causes of the current discontent. In this climate of uncertainty it is vital to stand back from the fray to be able to identify the basic economic trends which provide the long term indicators for investors and businessmen.

In the Far East, where trade plays a very important role in the development of the region it is essential to consider the interaction between economic policies in different countries. Often external factors can completely dominate the domestic economy and considering a country in isolation is liable to lead to serious misunderstanding of its prospects and problems. For each of the countries reviewed, ASIAN MONETARY MONITOR emphasises the external factors involved.

This issue examines the reasons for the strength of the Japanese Yen and the consequences of recent monetary policy in Australia are considered as a background to the election campaign. The enigmatic money supply of Hong Kong is analysed in relation to foreign monetary policy and the behaviour of the Singaporean economy is compared with Hong Kong and Japan. Readers are invited to submit any suggestions or comments to the editor and to circulate the publication to other potential readers.

KEY TO SYMBOLS USED IN THE CHARTS

% RP - Percentage Rate of change over Preceding period.

% RS - Percentage Rate of change over Same period of preceding year.

SA - Seasonally Adjusted.

SAAR - Seasonally Adjusted at Annualised Rate.

AUSTRALIA

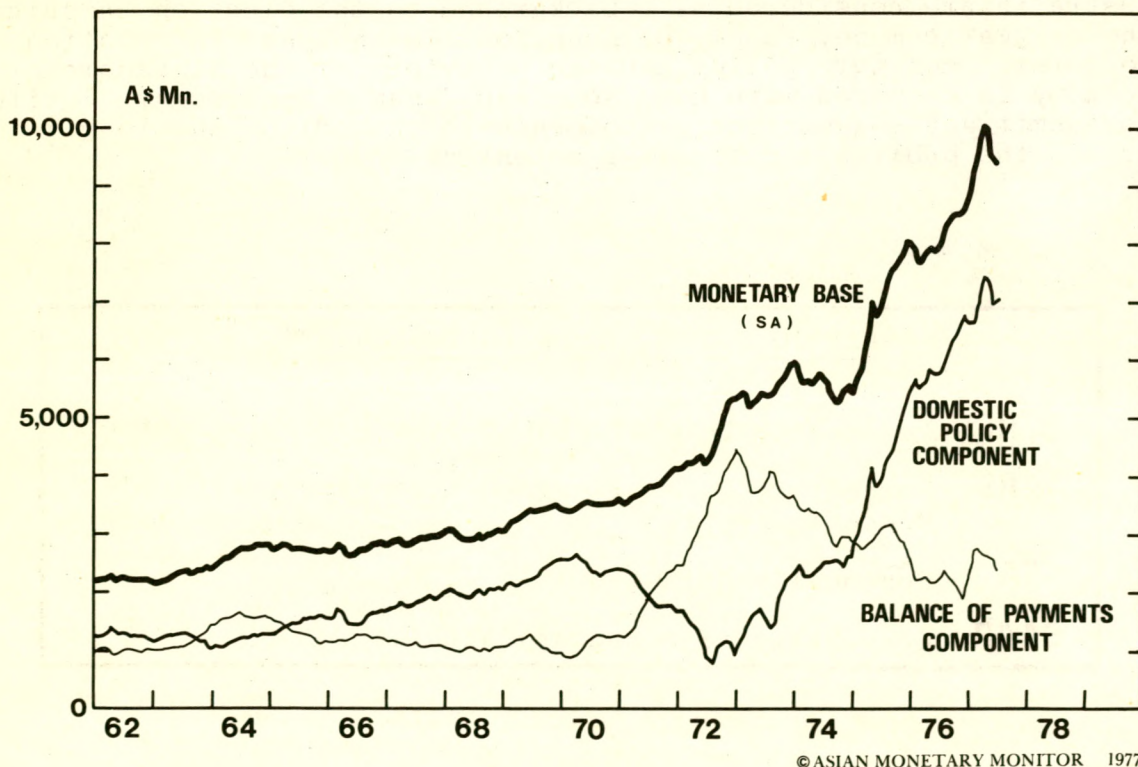
THE TURNAROUND WILL NOT BE RAPID

In 1975 there was a costly error in Australian monetary policy. Having taken the painful but necessary action between late 1973 and September 1974 to correct the disastrous over-expansion of the money supply, the authorities then threw away everything they had achieved by allowing a second wave of monetary expansion from October 1974 to September 1975.

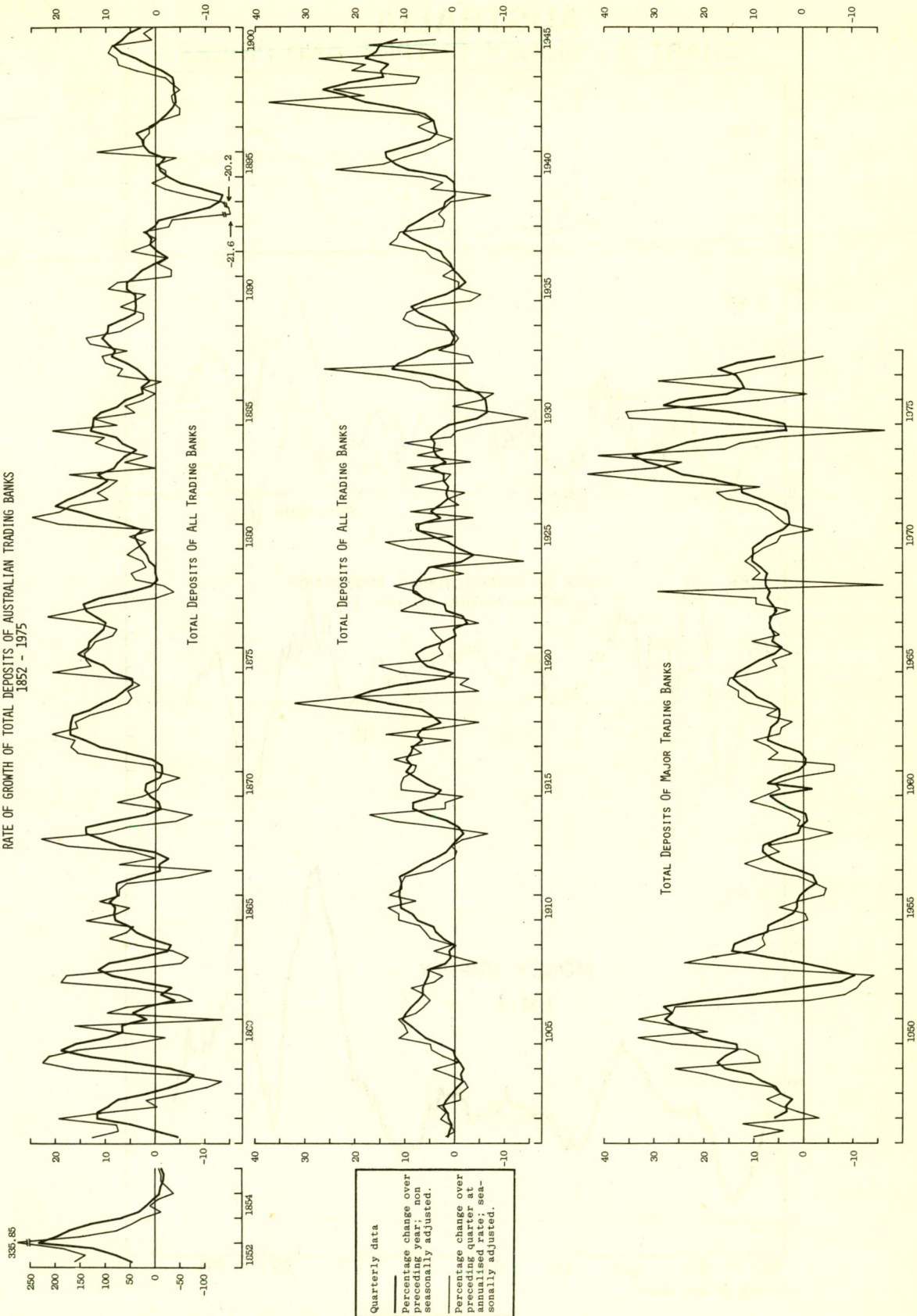
Up until mid-1972 the Australian authorities appear to have successfully controlled the growth of the monetary base (Chart 1). This was achieved by countering balance of payments surpluses (or increases in net foreign exchange reserves) with sales of Reserve Bank holdings of government securities. But with the burgeoning budget deficits of the Whitlam government, the monetary authorities appear to have acquiesced in 1975 in a decision to allow the monetary aggregates to grow at a rate only ever experienced in Australia in the 1850's, and again briefly during the period of the Korean War (1950-51) (Chart 2). Although the second wave of monetary expansion in 1975 produced a temporary resurgence in GDP and in manufacturing production, the cost of that short-lived recovery (illustrated in Chart 3) has undoubtedly been the long continuation of the high rate of consumer price inflation and the associated weakness in the Australian dollar. For while real growth was indeed recovering,

AUSTRALIA

CHART 1 : MONETARY BASE AND COMPONENTS

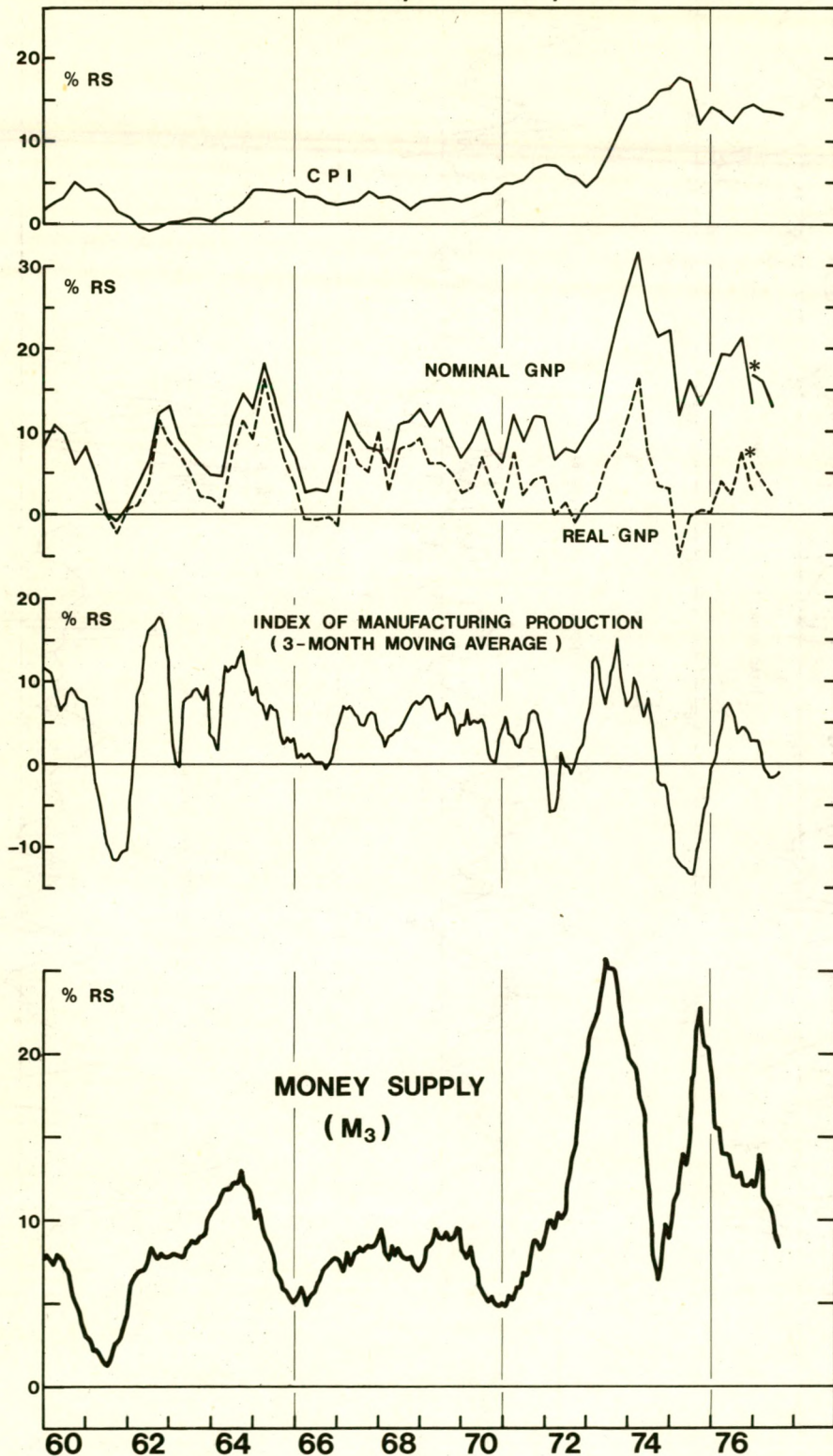


RATE OF GROWTH OF TOTAL DEPOSITS OF AUSTRALIAN TRADING BANKS 1852 - 1975



AUSTRALIA

CHART 3 : MONEY, OUTPUT, AND PRICES



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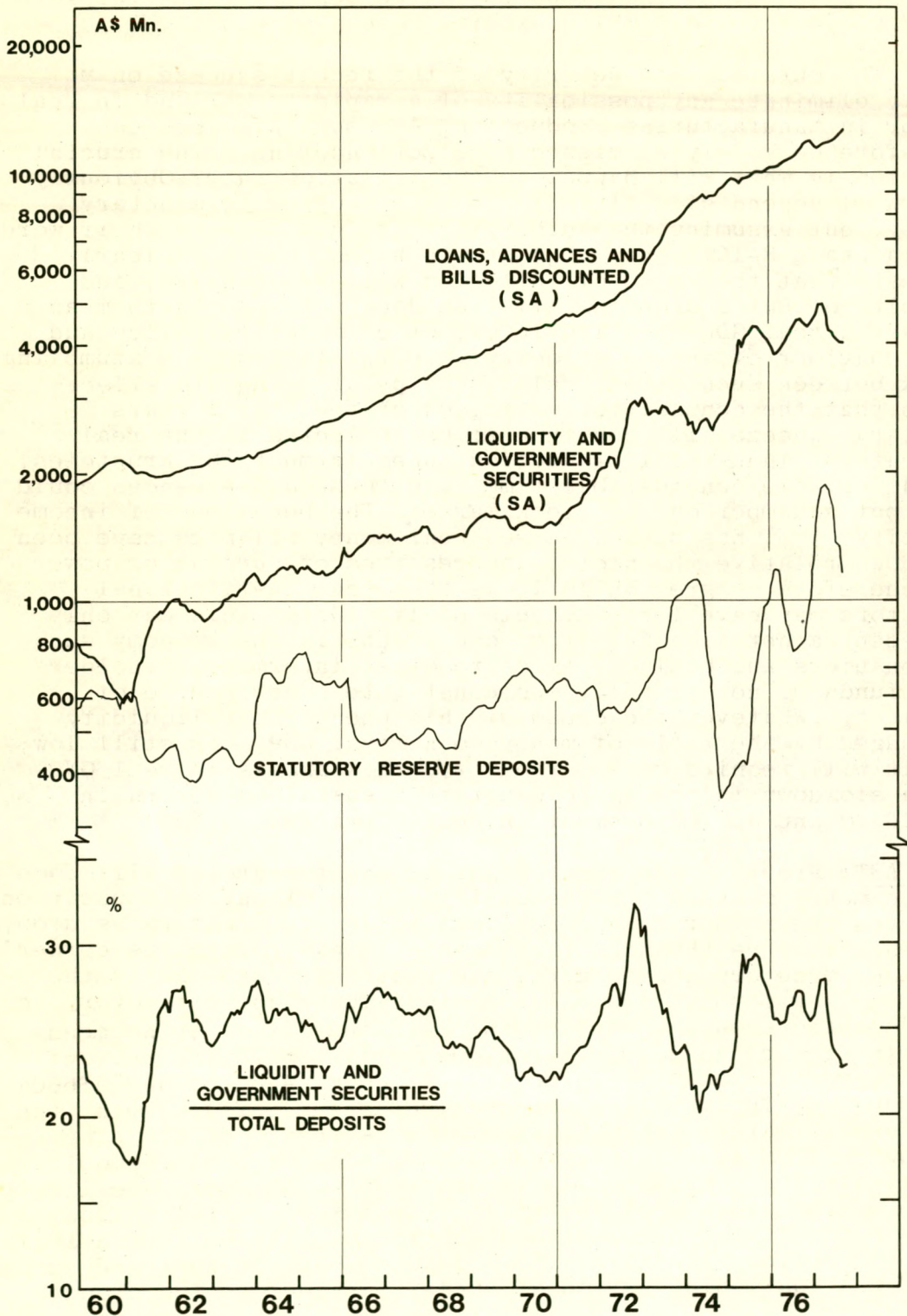
domestic nominal spending rates have also remained high, resulting in more spending on imports than would otherwise have been the case. Thus imports in the September quarter were up 17.9% year-to-year while exports rose just 6.4%.

The duration and severity of the recent squeeze on M_3 surely eliminate any possibility of a rapid turnaround in real GDP or in manufacturing production. Any such promises can therefore be safely dismissed as electioneering. The crucial question is what will happen to the inflation rate? Obviously this will depend significantly on what happens to monetary policy, but assuming the authorities are now true to their word and maintain 8-10% money (M_3) growth rates, Chart 3 clearly suggests that the trend of inflation will be downward, and sharply so. But a drop in inflation does not ipso facto mean a rise in real GDP: the lag in effect of monetary policy and the behaviour of income velocity (GNP/M_3) interpose a stumbling block between such direct relationships. The lag in effect means that the contractionary impact of the past 2 years monetary squeeze will continue to be reflected in the real indicators (industrial production, unemployment, bankruptcies, etc.) for some considerable time, and these consequences could well put a damper on the stock market. The behaviour of income velocity, too, has been adverse. Real money balances have been run down relative to income, and reserves of purchasing power are therefore meagre. While it is true that institutional investors may have large amounts of liquidity, this can only represent a net transfer from some groups in the economy such as consumers and business firms to other intermediary holders. Such funds do not on their own constitute a new source of liquidity. Whatever the cause of this phenomenon, liquidity - as judged by the ratio of money to nominal GNP - is still low, and it will require some period of both weakness in real GNP and a slowdown in prices to generate a sustained upturn in liquidity and an improvement in equity prices.

FORECAST: Probably the first signs of the turnaround will come in the money markets. As the basic balance of payments position improves the authorities can afford to let interest rates drop, and this will be the sign that Australia has turned the corner. A steady monetary course after the protracted squeeze is therefore the key to both the balance of payments and a recovery in the domestic economy. But having said that it is by no means easy to predict when that turnaround will come. The current balance remains heavily in deficit (A\$669m, A\$636m, and A\$660m (unadjusted) in the first three calendar quarters); Japan, the main export market, shows little or no evidence of stepping up purchases from Australia - indeed purchases of U.S. commodities to satisfy the demands of American trade negotiators are likely to be at the expense of Australia; and large capital inflows for private investment or government borrowing will be increasingly hard to obtain. In short, the prospects both at home and abroad are for a continuing period of uncertainty before the clouds lift.

AUSTRALIA

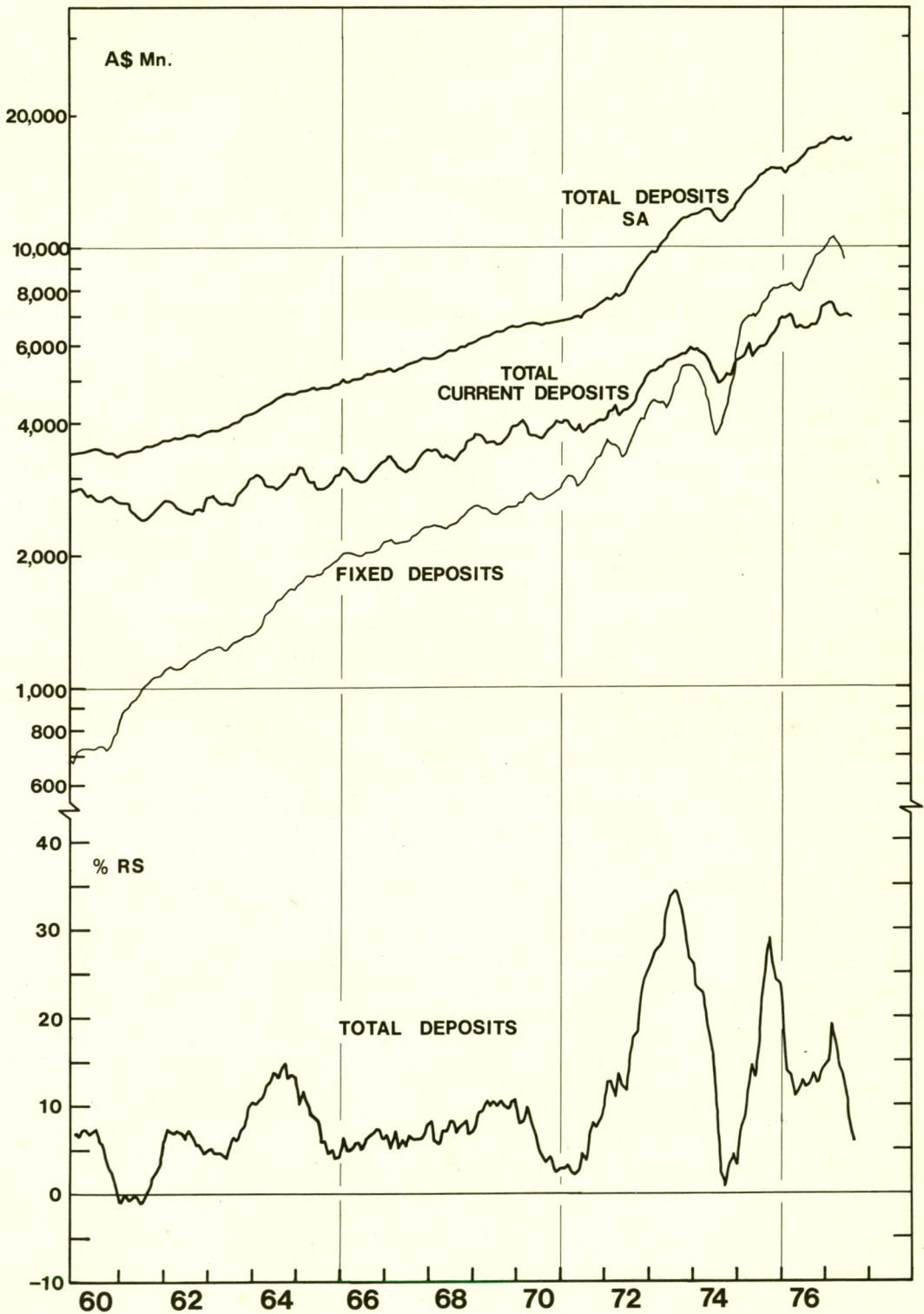
CHART 4 : BANK ASSETS (MAJOR TRADING BANKS)



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AUSTRALIA

CHART 5 : BANK LIABILITIES (MAJOR TRADING BANKS)



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WHAT DETERMINES THE MONEY SUPPLY ?

The monetary system of Hong Kong has undergone radical changes in the last ten years. In 1967 Hong Kong was firmly anchored to a Sterling Exchange standard, embedded in the Sterling area in a world of fixed exchange rates, but today the colony has substantial freedom in monetary affairs, the Hong Kong dollar floats and the foreign reserves are mercifully spread among several currencies. In the domestic field the financial institutions have witnessed an invasion by foreign competitors, a stock market boom and a catastrophic crash. The government has extended its legislation over financial markets and now abstains almost entirely from intervention on the foreign exchanges.

What are the implications of these developments for the behaviour of the money supply? The question is peculiarly intractable in the case of Hong Kong. In the first place, Hong Kong is exceptional in having no Central Bank able to regulate the reserve base of the banking system. Secondly, a major portion of the reserve base is in the form of foreign currency assets about which there is no available information. In short, the foundations on which monetary expansion takes place are well and truly buried out of sight.

Fortunately the money supply is not solely determined by the reserve base. Variations in the behaviour of the public and the banks also play an important part. Generally the more the banks are inclined to make loans in the domestic economy and the more funds are deposited with the banks by the public, the greater the growth of the money supply. Thus, for example, if the public is inclined to increase its ratio of deposits to cash there will be an expansionary effect on the money supply; and if the banks reduce the amount of loans there will be a contractionary effect.

Does the public have a significant effect on money growth? One measure of public behaviour is the cash/deposit ratio (Chart 1). This ratio varies little in the short run and has shown a secular decline as the use of banking facilities has spread throughout the population. The growing number of bank branches and the greater use of cheques and financial transactions corresponding to the increasing affluence of the population have reduced the need to hold cash currency. The ratio has now stabilized at a level similar to that in most developed nations - perhaps indicating that the diffusion of the banking habit has reached its limit. It is therefore unlikely that the ratio will change much in the years to come so it will probably not be a significant factor in determining changes in the money supply. That is not to say it has exerted no influence in the past. In 1967 the major banking crisis showed up clearly in the cash/deposit ratio when a run on the banks - a massive conversion of deposits into cash currency - caused a sudden dip in the growth of M_2 . It is only in the event of another such run on the banks that changes in the ratio will appreciably influence money supply.

The overall demand for money (the sum of cash and deposits) cannot be measured directly, because the money 'supply' statistics represent the outcome of the interaction between the demand for money in the economy and the banks' response to that demand. However, it is likely that the demand for money is fairly stable and grows with the long-run growth in GDP so the supply behaviour of the banks plays a more important role in determining the short-run variations in monetary growth.

The major change in the banking system since 1970 has been the arrival of foreign banks and 'wholesale' banking. Of the 74 licensed banks 31 are foreign and most of the 25 local Chinese banks are dominated by banks overseas. In addition the number of representative offices of foreign banks more than doubled between 1972 and 1976 when there were 93. However, the impact of foreign banks on the money supply figures is probably small because the great majority of their business is in off-shore loans and it is unlikely that more than a fifth of the total assets of the Deposit Taking Companies (DTC's) are in Hong Kong dollars. Though they undoubtedly have deposits at the 74 licensed banks the DTC's are, at present at least, unimportant in the money creation process.

This leaves the licensed banks - their reserves and their behaviour - as the main determinants of the money supply changes. Unfortunately it is difficult to extract a clear picture of the behaviour of the banks from the published statistics. A traditional measure of the aggressiveness of the banks' lending policy has been the loans/deposits ratio. As can be seen from Chart 1 this ratio indicates a dramatic change in lending policy since 1973, and for most of 1977 the ratio has been around 100%. This

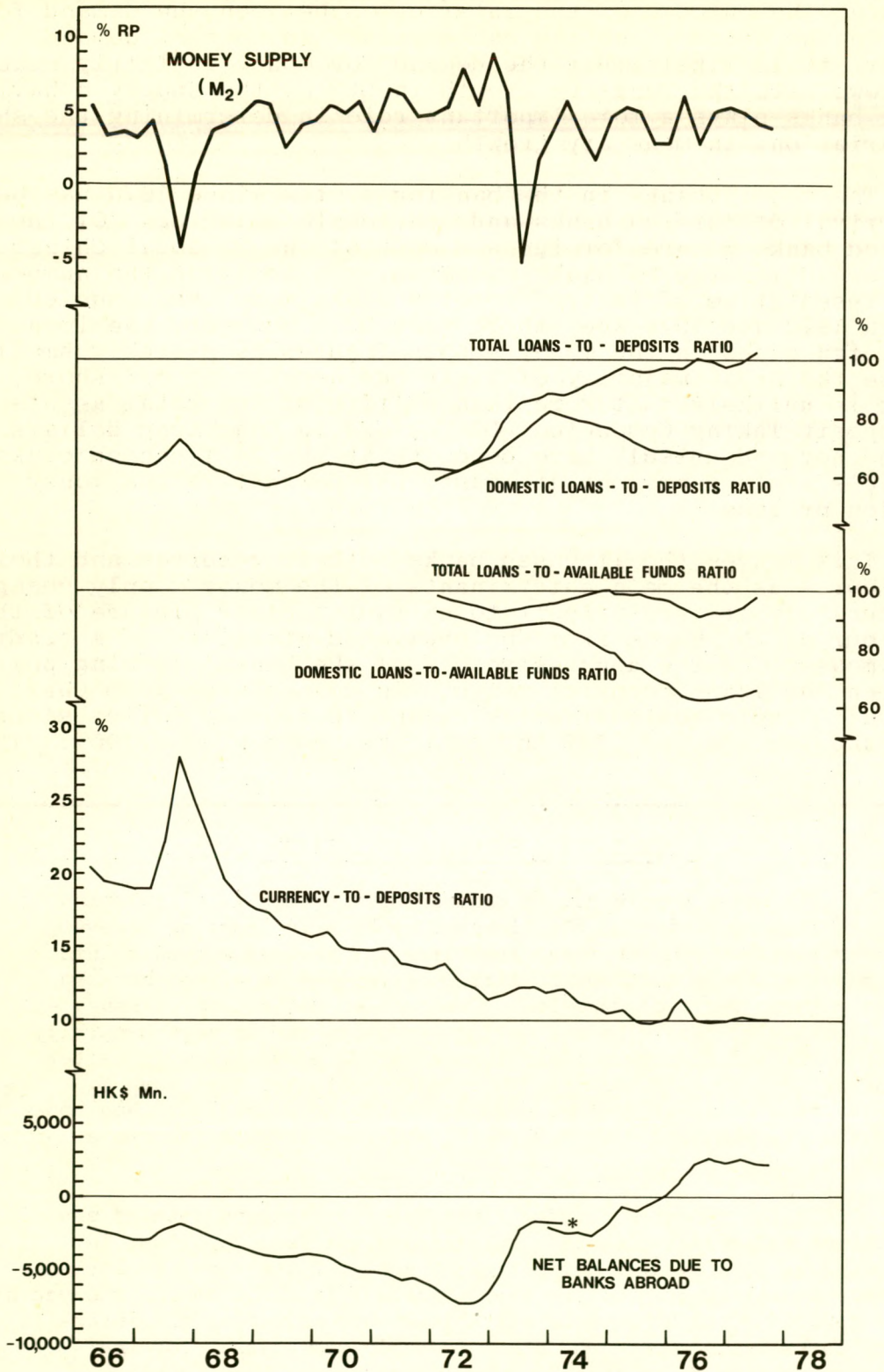
THE MONEY SUPPLY - DEFINITIONS

The money supply M_1 , is defined as the cash in circulation plus demand deposits at the licensed banks. In practice however it is easy to transfer money from Time and Savings accounts into Current accounts so there is little difference in effect between these three types of deposits. The broader definition of money - M_2 , equals M_1 plus Time and Savings deposits and is more generally used. M_1 and M_2 show similar trends but M_2 grows slightly faster in the long run. M_1 on the other hand fluctuates more than M_2 reflecting seasonal factors such as the Chinese New Year when money is transferred into demand deposits and cash is withdrawn in a general spending spree.

At the moment secondary financial institutions such as savings schemes and credit finance companies are not very important in Hong Kong so a broader definition of money, M_3 , defined to include their deposits would not be very different from M_2 , but in the years to come an M_3 might be more suitable when considering the interaction between 'money' and other economic variables. For the present though M_2 is probably sufficient.

HONG KONG

CHART 1 : MONEY SUPPLY, BANKING PRACTICE AND PUBLIC BEHAVIOUR



* Before 1974, time deposits are excluded.

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however is a fault in the statistic rather than in the banks, as it fails to distinguish between their domestic and foreign business. A better indicator of overall banking behaviour is the ratio of loans to available funds, defined as the sum of deposits and net borrowing from banks abroad, though the data required to calculate the ratio go back only five years. This ratio displays no such dramatic change in 1973 and it appears to exhibit no long-run trend, but the share of Hong Kong dollar loans (approximately corresponding to loans in the domestic economy) in the overall lending activity of the banks has declined since 1973 giving way to their expanding foreign business. Since 1971 the total amount due to banks abroad has risen 930% compared with a rise of only 100% in deposits, indicating that on the liabilities side also, foreign business has greatly increased in importance for the licensed banks.

A major consideration for the money supply is the extent to which domestic deposits are recycled into the domestic economy as loans, indicated by the domestic loans/deposits ratio. A rise tends to increase the money supply, and a fall tends to reduce the money supply. Notice, however, that the ratio reached over 80% in 1973 when the growth of M_2 was at its lowest since 1967. Had the banks held the ratio constant in 1973, the drop in the money supply would have been far greater. It is true that the ratio had begun to creep up during the monetary expansion and the stockmarket boom of 1972 as banks increased their loans to investors and stockbrokers, but the subsequent behaviour of the banks, whether by choice or necessity, appears to have played a stabilizing role in the economy. The banks, faced with many bad debts and a reduced deposit base (Chart 3) after the crash, borrowed from abroad to bridge the gap as can be seen in the sharp rise in the net balances due to banks abroad.

Question: When is a bank not a bank?

Answer : When it is a Deposit Taking Company.

There are 74 licensed 'banks' in Hong Kong and they must satisfy various requirements laid down in the Banking Ordinance. In addition there are 200 registered Deposit Taking Companies which need satisfy less rigorous requirements but which are not permitted to call themselves 'banks' and cannot take small deposits. In 1973, before the regulations were tightened up, it was estimated that there were over 2,000 of these companies, but when obliged to register only 200 turned up this year! The stockmarket crash and the new regulations obviously proved too much for many of the shakier institutions.

With the arrival of large numbers of 'representative offices' of foreign banks the distinction between banks and non-banks has become farcical; large multinational banks are obliged to hide behind pseudonyms because they have been refused licenses to call themselves banks, and it is likely that the regulations will be changed in the near future.

It is only recently that the Banking Commissioner has begun to collect data on the 'non-banks' and their deposits are not included in the official definition of Money Supply.

Why the net balances did not return to their former level after the dust had settled is a matter for conjecture. Perhaps with the advent of floating exchange rates in 1972 the opportunities for making profits on borrowing from abroad increased. For instance, a revaluation of the Hong Kong dollar against the U.S. dollar would reduce the burden of a debt denominated in the latter currency. Of course, the banks also run the risk of a depreciation of the Hong Kong dollar which may jeopardize any profit due to the yield spread between U.S. dollar borrowings and H.K. dollar loans. It should be noted that foreign borrowing in order to expand domestic credit is explicitly using foreign funds to generate new credit in Hong Kong.

In practice it is unlikely that the banks do expose themselves to exchange risk in this way to any great extent, but there is a second channel through which an implicit use of foreign funds can stoke a monetary expansion. A local branch of an overseas bank may borrow heavily on the interbank market in order to make domestic loans, knowing that it can always fall back on the reserves of the parent bank in an emergency. Thus a rise in the reserves of foreign banks may generate more aggressive lending in Hong Kong without any flow of funds across the foreign exchanges.

The third way in which foreign funds can generate monetary expansion is by an increase in the value of liquid foreign assets held by the banks arising from capital appreciation of foreign securities or a direct inflow via the balance of payments. In practice the balance of payments flows are likely to dominate all other foreign influences on credit expansion but no figures are available to confirm this view.

Overall it appears that external factors in general play an important role in determining monetary expansion in contrast to the minor (and stable) role usually exhibited by the internal factors - public behaviour and banking practice.

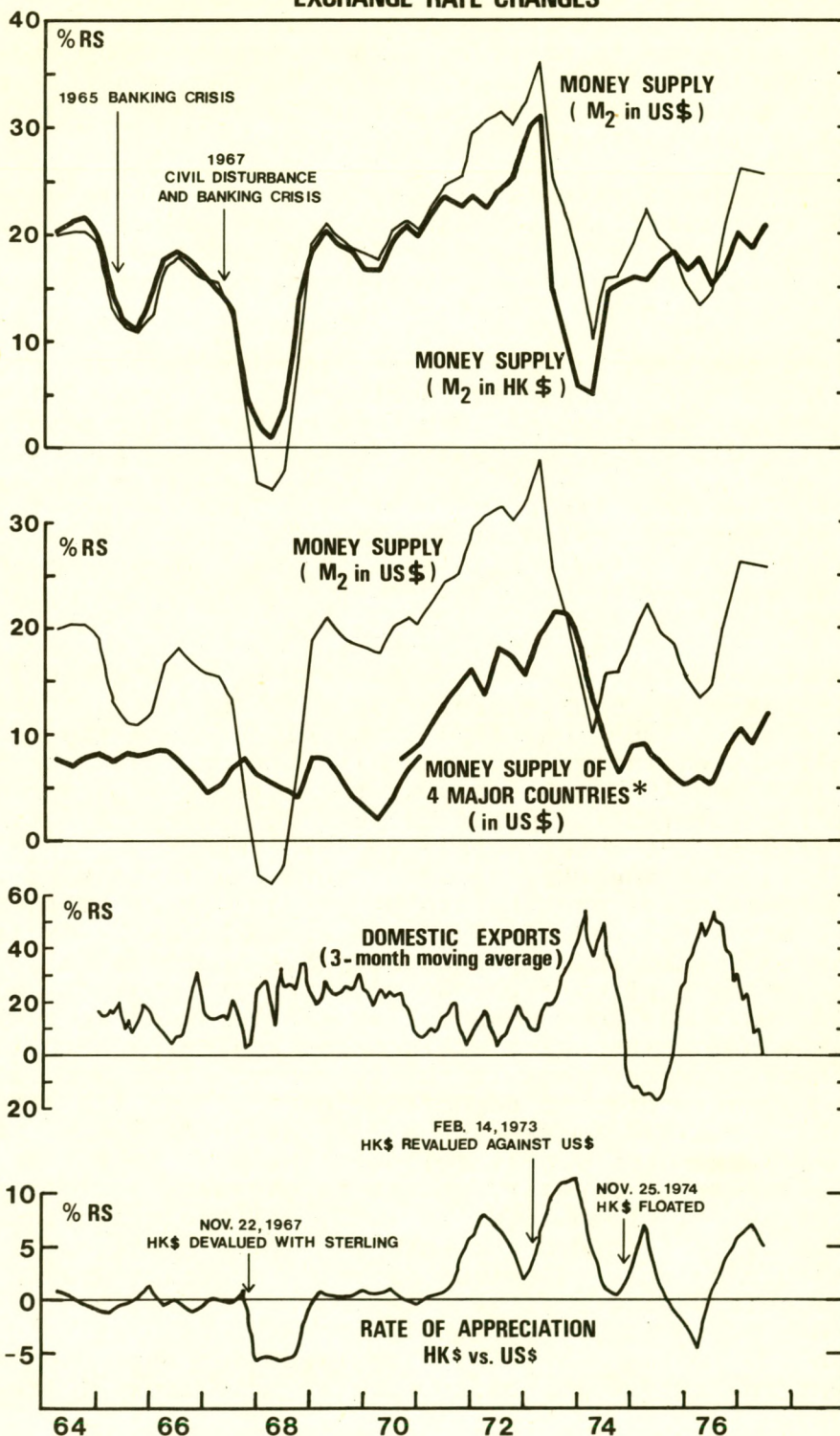
Foreign Monetary Policy

Is the money supply of Hong Kong related to the money supplies in other countries? There are several reasons for thinking that it might be. For instance, a monetary expansion in the U.S.A. is likely to affect Hong Kong's balance of payments in two ways. Firstly, the expansion of demand in the U.S.A. would increase demand for Hong Kong exports and secondly, the inflation associated with accelerated monetary growth may induce a flow of capital into Hong Kong fleeing from a weak U.S. dollar. These two factors would cause the demand for Hong Kong dollars to increase relative to supply.

If the exchange rate were allowed to float to bring supply and demand into equilibrium the effect on the reserve base of the banking system would be minimized and the change in the Hong Kong money supply would be small. On the other hand, if the exchange rate were pegged the foreign reserves of the banking system would rise. The rise would be less if part of the exchange

HONG KONG

CHART 2 : MONEY SUPPLY, FOREIGN MONEY SUPPLY AND EXCHANGE RATE CHANGES



* US, UK, JAPAN, W. GERMANY
(before 1971, US and UK only)

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were between holders of foreign currency deposits and domestic currency deposits both held by banks in Hong Kong, as this would leave the reserves of the banking system unchanged and the effect on the money supply would be further mitigated if the banks did not match an increase in reserves with a corresponding expansion of credit. But overall the link between foreign monetary policy and domestic money supply will be strong, provided - and this is crucial - that the exchange rate is pegged.

If the exchange rate is allowed to float, the reserves of the banking system will be affected to a much lesser extent and indeed, an appreciation of the Hong Kong dollar would lead to a fall in the Hong Kong dollar value of existing reserves and inflows would be required to top them up.

To test the relationship between foreign monetary growth and Hong Kong's money supply we constructed an index of the money supply growth in US\$ terms of Hong Kong's four major export markets, the U.S., U.K., Japan, and West Germany. The rate of growth of the Hong Kong money supply in U.S. dollars was also computed (the two thin lines in Chart 2). This represents the growth in the external value of Hong Kong's money supply, and thus incorporates the two variables upon which foreign monetary expansion is expected to have an effect - domestic money and the exchange rate.

From the chart it can be seen that Hong Kong's money supply measured in US\$ shows poor correlation with foreign or 'world' money supply up to 1969, but this is mainly because the domestic money supply was dominated by internal disturbances - the banking crises of 1965 and 1967. Thereafter the correlation is remarkably good. An interesting point is that the sharp fall in the rate of growth of the money supply in 1973 occurred before the downturn in foreign monetary growth. This can largely be attributed to circumstances peculiar to Hong Kong. Part of the monetary expansion towards the end of 1972 was caused by banks expanding their loans to stockmarket speculators, but there was also an inflow of foreign capital eager to ride the stockmarket boom. On February 14, 1973 the Hong Kong dollar was revalued against the U.S. dollar and foreign speculators began realizing both their gains in the stockmarket and in the currency. This process must have caused a sharp drop in deposits (Chart 3) and the reserves of the banks. The stockmarket bubble burst three weeks later and the Hong Kong money supply followed the Hang Seng index as it plummeted to earth. Monetary growth in overseas economies only began to run out of steam later in 1973, and the deflationary force of the oil crisis did not have its full impact until 1974. Apart from this notable exception, foreign monetary growth and Hong Kong monetary growth (in US\$ terms) have moved pretty much in step. But it is the money supply measured in Hong Kong dollars rather than U.S. dollars which is important for the domestic economy, and to analyse the difference we must look at the exchange rate changes.

Until 1972 the Hong Kong dollar was firmly pegged to Sterling and its parity with the U.S. dollar changed little (except when Sterling devalued in 1967) so the money supply growth in US\$ terms was closely matched by the HK\$ money supply growth. However, in

the 1970's large cracks began to appear in the world monetary edifice and major realignments of currencies took place. The passage of the Hong Kong dollar through those troubled times was outlined in the previous Asian Monetary Monitor, but the point which concerns the money supply is that since the early 1970's the exchange rate against the U.S. dollar has moved more frequently in response to changes in the balance of payments.

It is clear from Chart 2 that from 1973 it has been the exchange rate rather than the domestic money supply which has absorbed the fluctuations in foreign monetary policy. Since November 25, 1974, the Hong Kong dollar has been allowed to float with minimal official intervention on the foreign exchanges so the variations in the level of the foreign reserves of the banks via inflows on the balance of payments have been greatly reduced. The reduced effect on the reserves is reflected in the Hong Kong dollar money supply which has shown only slight response to external monetary factors since that date, while the money supply in US\$ terms and foreign money supply have continued to move closely together.

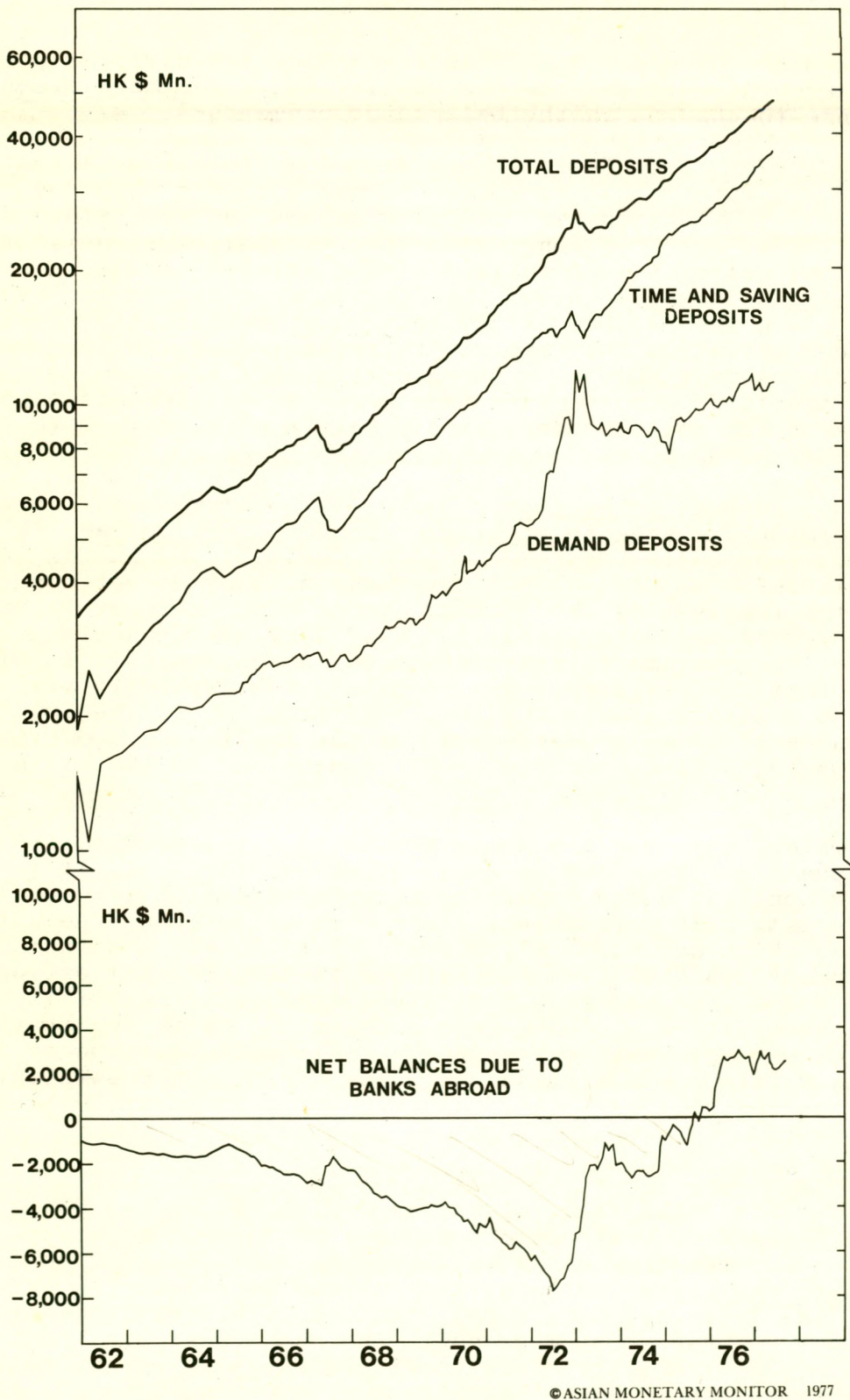
Under current arrangements, when the government intervenes on the foreign exchange to stabilize the Hong Kong dollar, the foreign currencies it buys and sells are held by the Exchange Fund and are invested almost entirely overseas so they do not constitute part of the reserves of the banking system. In the past three years therefore the money supply of Hong Kong has been virtually unaffected by government intervention on the exchanges. Insofar as the domestic money supply has continued to respond to variations in foreign monetary growth this may be attributed to the imperfect operation of the foreign exchanges, or the implicit use of foreign liquid assets to back domestic credit expansion, in the way already described.

However, now that the money supply is set free from its foreign shackles there may be some surprises, for while it is true that Hong Kong can avoid importing foreign inflation it may also suffer domestically generated inflation uncorrected by the automatic stabilizer which operated in the past. Fortunately monetary growth appears to have been more stable in the era of floating exchange rates than under pegged rates (suggesting that it is foreign monetary authorities who have been rocking the boat), and that left to its own devices Hong Kong's money supply will continue to grow at a steady rate. But with no controls on monetary growth this is by no means certain.

FORECAST: Under the floating exchange rate regime the money supply of Hong Kong will be less subject to foreign monetary policies. For the time being these forces are likely to be expansionary: the appreciation of the yen has increased the external value of the Japanese money supply, and the U.S. continues on its expansionary course. But whereas in the past these pressures would have been transmitted via the fixed exchange rate into rapid monetary expansion in Hong Kong, now that the Hong Kong dollar floats the effect will be greatly reduced and it is therefore unlikely that there will be much acceleration in the growth of Hong Kong's money supply.

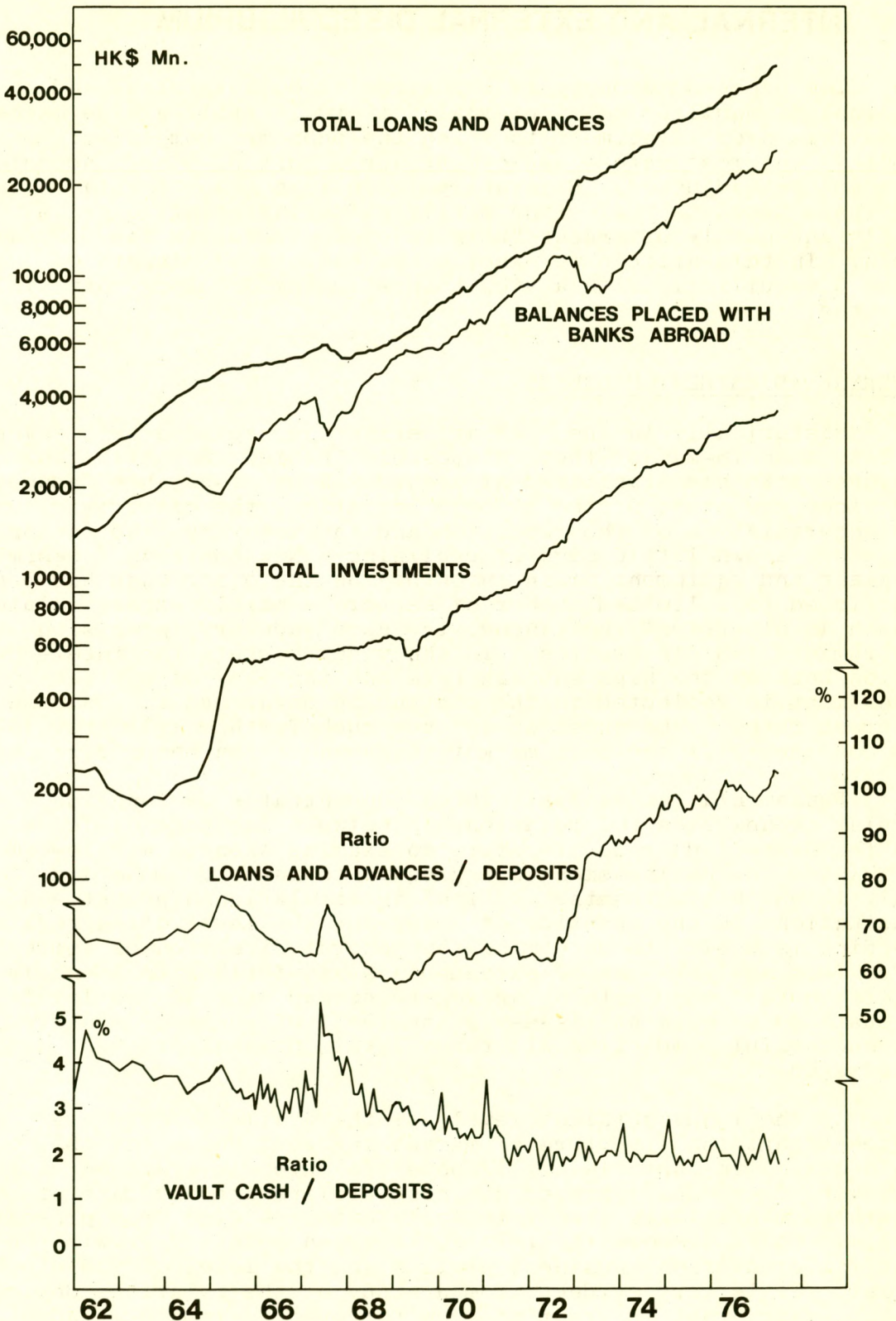
HONG KONG

CHART 3 : BANK LIABILITIES



HONG KONG

CHART 4 : BANK ASSETS



INTERNAL AND EXTERNAL DISEQUILIBRIUM

The Japanese economy is experiencing both internal and external disequilibrium. Internally there is still a wide excess of savings over investment to which the economy, companies, profits, interest rates, employment and a host of other indicators have not yet adjusted. Externally there is a major imbalance in the trade accounts reflecting partly differing relative price levels and partly divergent business cycle trends in the U.S. and Japan. In this article we examine the basic determinants of these disequilibria with a view to predicting how long they will continue.

INTERNAL ADJUSTMENT PROBLEMS

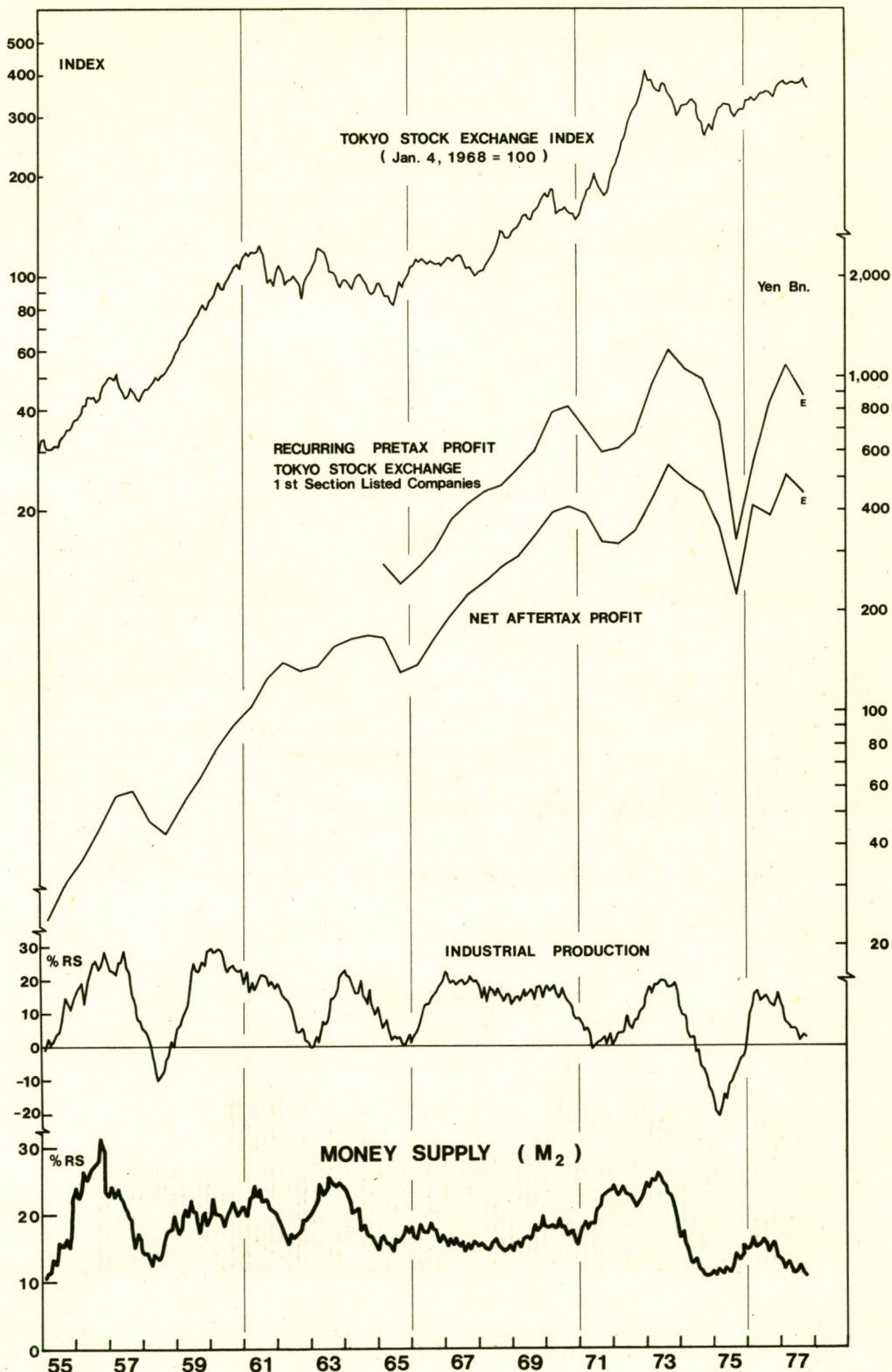
Historically in the postwar period the Japanese have saved no less than 16-24% of their disposable income. Recently the savings ratio has stabilised at around 23% of disposable income, and since the onset of the 1973-75 inflation, the oil crisis, and the uncertainties of the recession and the recovery, the savings ratio has shown little sign of declining. New business investment in plant and equipment or in inventory on the other hand has been restricted to a limited number of sectors - mainly export related - such as electrical appliances, the auto industry, precision instruments and electronics. In the money markets the interaction between the high savings rate and the lack of business investment is reflected in the continuing downtrend in Japanese interest rates. The question is, how much further will they fall, and how long will the bull market in Japanese yen bonds continue?

Fundamentalist analysis which concentrates on long run secular trends uses the relationship between the cost of funds and the (expected) rate of return to examine when it will become worthwhile for businessmen in aggregate to invest. Monetary analysis which studies the cyclical interrelationships between fluctuations in the quantity of money and the level of aggregate spending is useful to determine the general direction of nominal GNP. This analysis can be extended a stage further to identify shifts in the components of aggregate demand such as the level of business investment vis-à-vis the level of consumer spending. For successful prediction all three levels of analysis must be integrated.

At the fundamentalist level all the available evidence suggests that the structure of market interest rates (or the yield curve) in Japan is still above the rate of return on capital. Moreover, as we shall argue, business profits and the rate of return on capital are likely to fall further - even from present levels. Chart 1 shows the relation between monetary growth, industrial production, business profits and the level of the stock market. It is very evident from a study of the relations depicted in this chart that in order to grow (or even to remain steady) business profits require a background of healthy growth in industrial production. But the stock market, which has in postwar

JAPAN

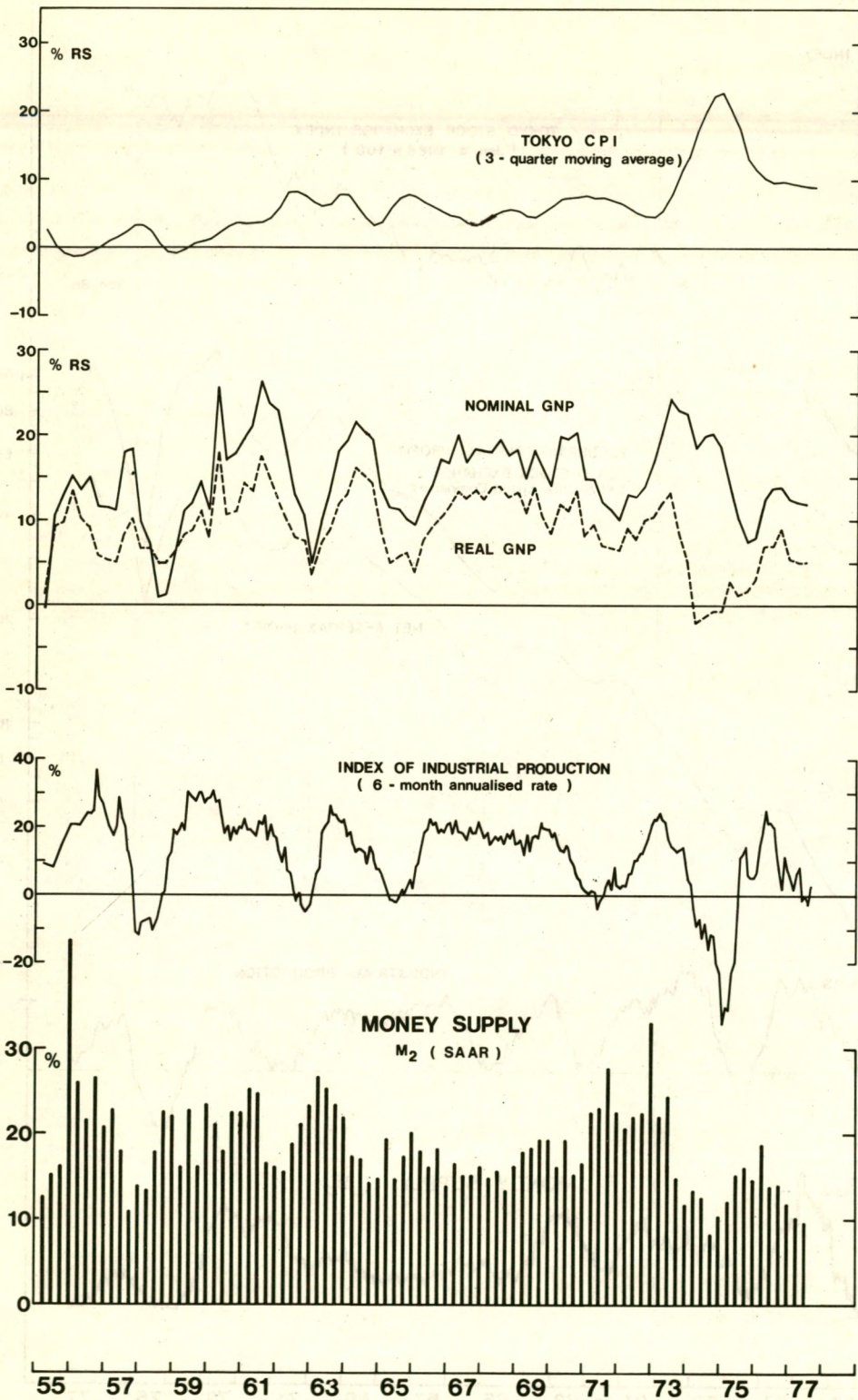
CHART 1 : MONEY, OUTPUT, PROFITS AND STOCK PRICES



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JAPAN

CHART 2 : MONEY, OUTPUT, AND PRICES



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cycles always correctly anticipated the level of business profits (with a notable exception in 1963-64), has been on a plateau throughout most of 1977, and yet industrial production has been decelerating since mid-1976. On a year-to-year basis industrial production is virtually flat and the odds must be on continued weakness given the present stance of monetary policy and the present yen exchange rate. It is hard to escape the conclusion that the outlook for profits must therefore be gloomy, and the prospects for the equity market equally grim. Of course there will be some bright spots, but the overall level of the stock market must be considered vulnerable to a correction in the long term relationship between industrial production, profits, and the market index.

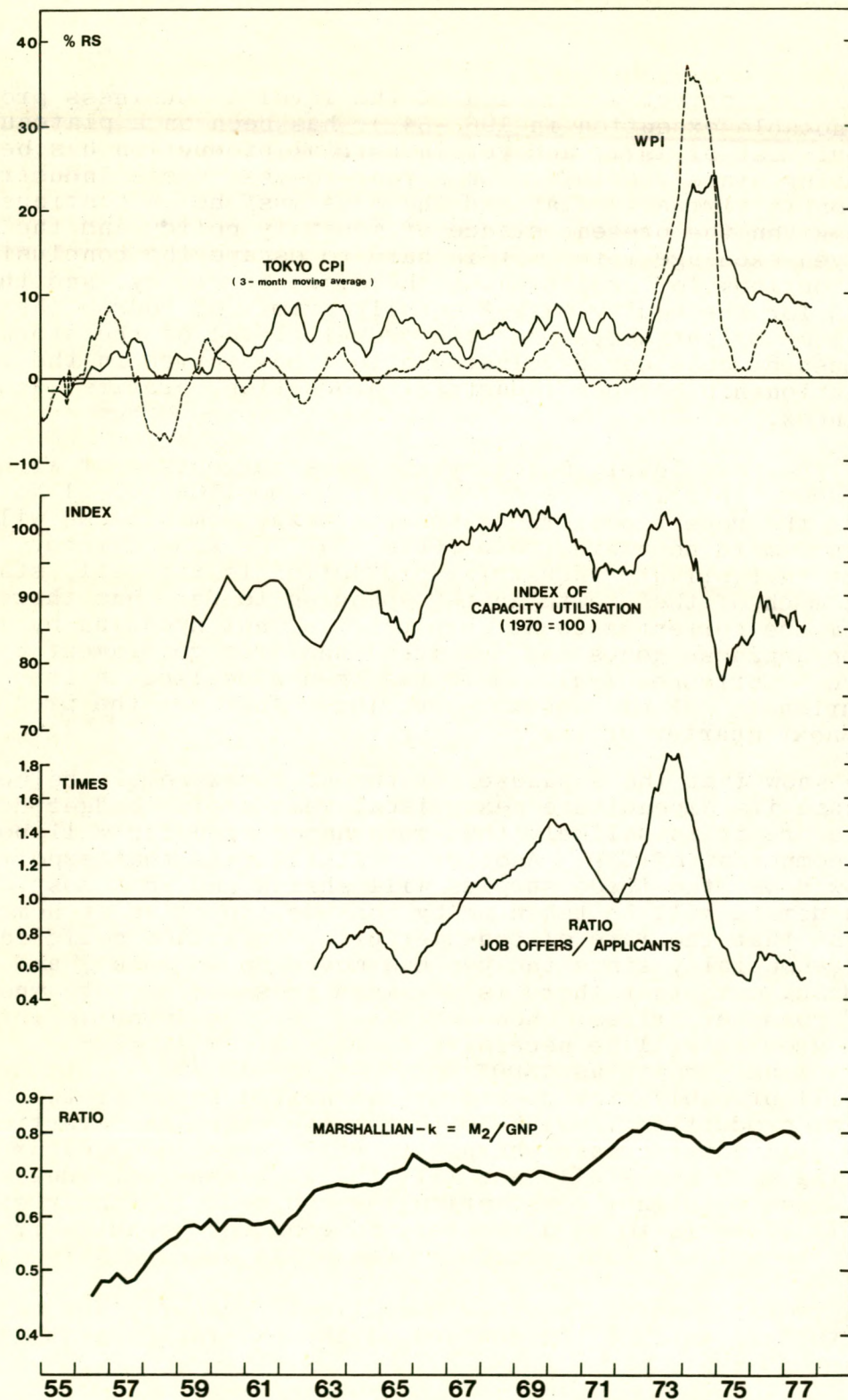
At the next level, monetary analysis suggests that with stable income velocity (see ASIAN MONETARY MONITOR Vol. 1 No. 1 p.16) and the recent pattern of money growth, nominal GNP will remain in a mild downward trend (Chart 2). We know already from the chart that private industrial production is virtually static and that much of the growth in GNP spending to date has therefore come from the current account surplus (i.e. net spending by foreigners on Japanese goods and services) and from government expenditure. Correspondingly there has been a decline in the contribution to GNP of consumer spending. What are the prospects for the next quarter or two?

We know that the Japanese government is extremely reluctant to increase its expenditure next fiscal year or its budget deficit, and therefore it is unlikely that government spending will be the leading component of GNP. Another possibility is that exports will slow down, the trade surplus will shrink and that most of the slack in demand will be taken up by consumer spending at home. It is true that the rate of consumer price inflation could fall sharply (especially since the yen has moved up so much), and Chart 3 indeed suggests that there is downward pressure on both wholesale and consumer prices. However, in order for spending in real terms to grow it will be necessary to maintain a similar rate of nominal growth as experienced so far in 1977. But nominal growth will probably slow down over the next quarter or two: industrial production is weak so that basic wages and overtime payments will not increase sharply in real terms; company profits are falling so bonuses will not fill the gap; and individuals show no signs of higher consumption through reducing their savings rates. If there is to be a recovery in consumer spending it is likely to be a long, slow process. Meanwhile uncertainties abound.

There is, however, another more likely scenario and for this we must turn to analyse the sources of the external disequilibrium.

JAPAN

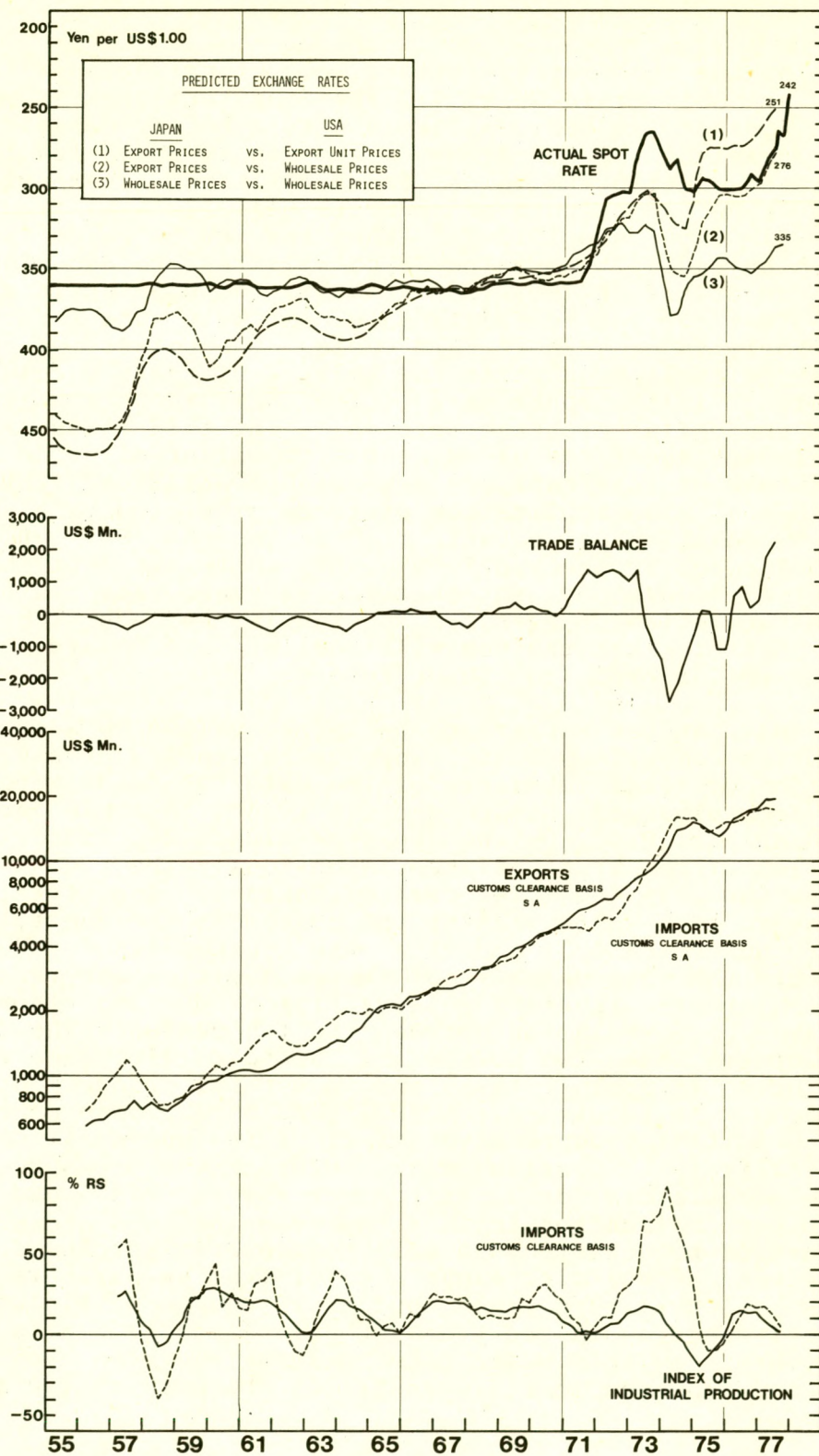
CHART 3 : LIQUIDITY, CAPACITY UTILISATION, AND PRICES



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JAPAN

CHART 4 : EXTERNAL TRADE, RELATIVE PRICES AND EXCHANGE RATE



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EXTERNAL IMBALANCE

Some of the fundamental factors accounting for the strength of the yen are set out in Chart 4. The long term secular value of the yen against the U.S. dollar is determined by relative price levels in Japan and the U.S.A. When the yen is above its long term predicted equilibrium value, Japan will tend to experience balance of trade and balance of payments deficits - as it did in 1956-57, 1961, 1963, and 1973-74. When the yen is below its long term predicted equilibrium value Japan will tend to experience surpluses, as it did in 1968-71, and as it has done again since 1976. Now that the yen is floating (albeit with some intervention by the authorities on a short term basis), the balance of payments surplus may be small, even while the balance of trade surplus may be very large. In the upper part of the chart the heavy line shows the actual yen/dollar exchange rate while the thin lines are theoretical exchange rates calculated from different price indices (for an example of this analysis see ASIAN MONETARY MONITOR Vol. 1 No. 1 pp. 5-10). The implication of these predicted exchange rates is that on a relative price basis with an assumed 1967 equilibrium, at ¥240 to the dollar the yen is probably above its equilibrium range. But it is also evident that the exchange rate can differ from these theoretical ranges for substantial periods. Thus it is perfectly possible that the yen will continue its upward move against the dollar even from these levels.

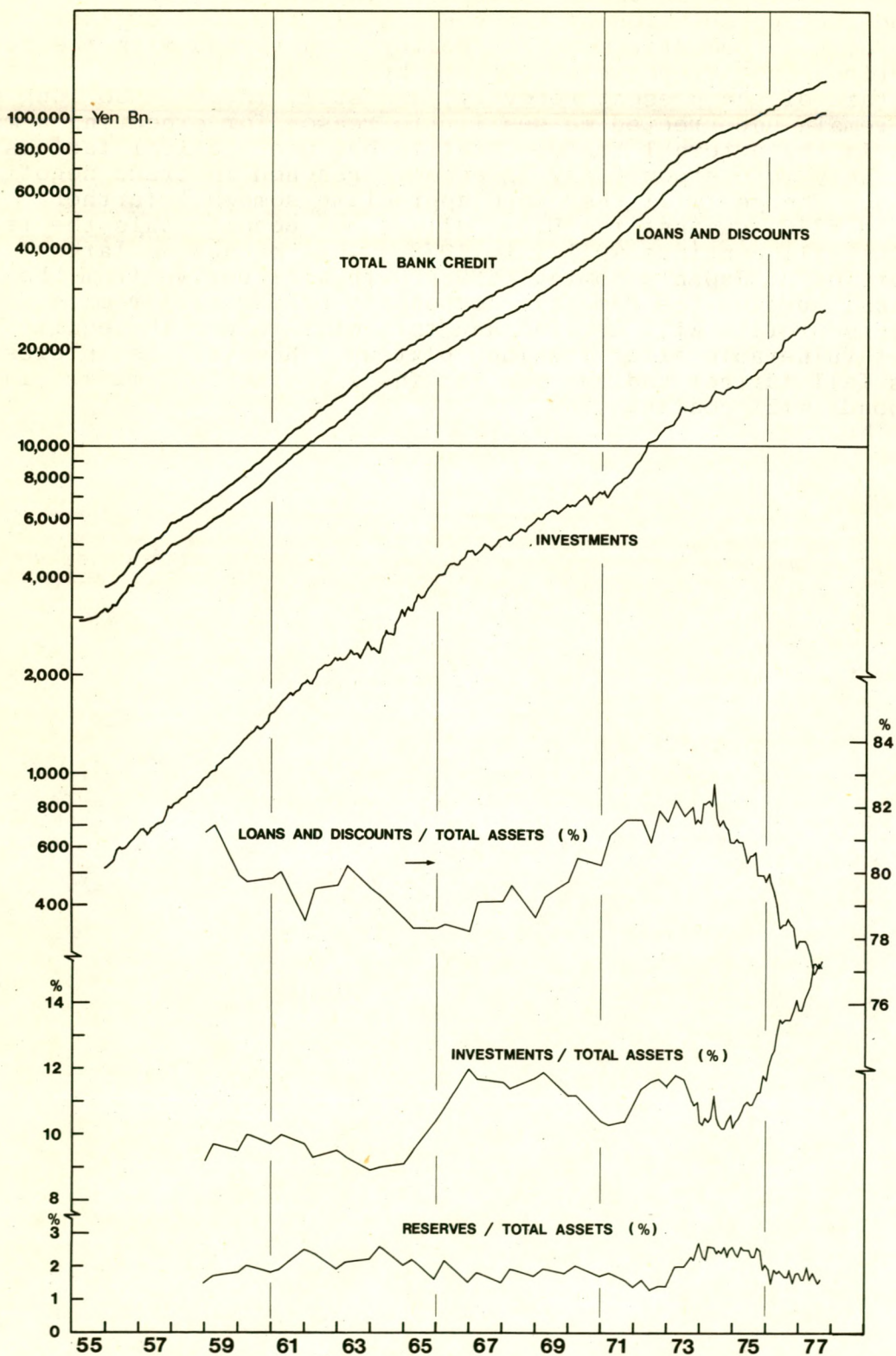
Now that the yen appears to be fairly valued on a secular, relative price comparison basis, any further upward pressure must be due to the cyclical imbalance of the external trade accounts resulting from divergent business cycle trends in Japan and her major trading partners. On the Japanese side a key factor in the determination of the trade balance is obviously the growth of imports, as shown in the lower part of Chart 4. Industrial production, shown as a solid line at the bottom of the chart, is the primary determinant of import growth (dashed line). Because Japan imports the vast majority of the commodities and raw materials which are the inputs for industrial production, there is a high degree of correlation between the two series. The deviations between these two series are due to mainly price changes - imports being in nominal terms and industrial production being in real terms. It is clear from the trend of Japanese monetary policy and the initially depressive effect of the appreciating yen that imports are likely to continue weak - despite the pressure from U.S. trade negotiators for Japan to increase imports - and therefore the clear implication is that the trade balance shown in the central part of the chart could well continue in surplus for a long while yet. Concerning Japan's major trading partners the pattern is obviously very mixed, but there can be little doubt that nominal spending in the U.S.A. continues to grow at a strong rate and that it is this basic clash between American cyclical expansion and Japanese monetary restraint which is at the heart of the issue.

FORECAST: Linking the analysis of internal and external disequilibrium the conclusion is blunt. The basic factors which caused the appreciation of the yen, namely the long expansionary force of U.S. domestic monetary policy* contrasted with the restrictive monetary policies pursued by the Bank of Japan since the start of the present recovery, are still intact. So long as they remain uncorrected we see little reason for expecting a major shift in the external trade situation because cyclical factors are likely to overpower any agreements reached in trade negotiations. The yen will therefore appreciate somewhat further (beyond ¥240) against the U.S. dollar, but despite this the trade surplus will continue well into 1978. Thus because a large proportion of Japan's nominal GNP growth will derive from the external surplus the domestic components of GNP will remain weak, business profits will decline and this will render the equity market vulnerable after its long plateau. However, as interest rates fall further and the yen remains firm the bull market in yen bonds will continue.

* See ASIAN MONETARY MONITOR Vol. 1 No. 1 pp. 2-4.

JAPAN

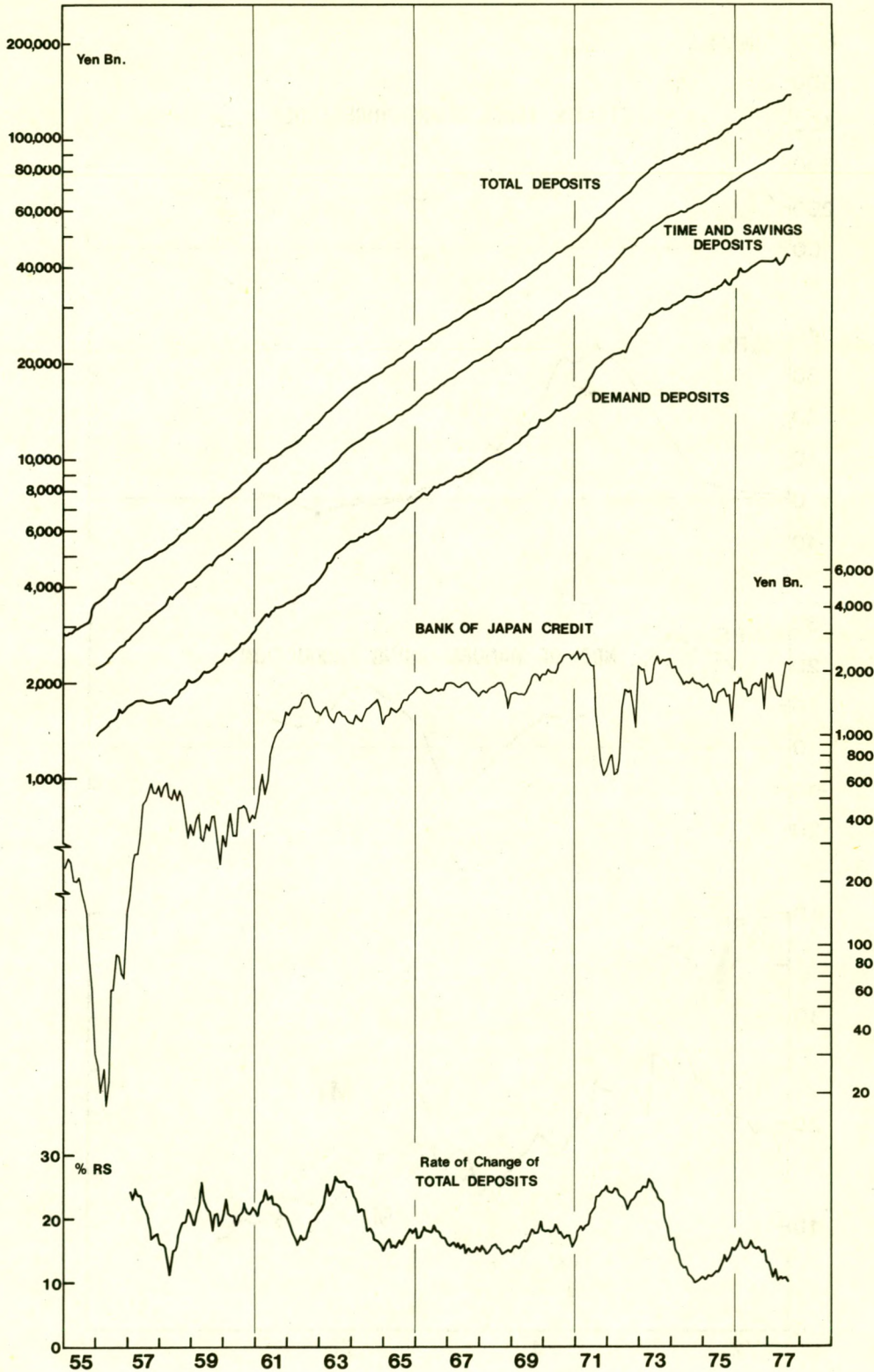
CHART 5 : BANK ASSETS



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JAPAN

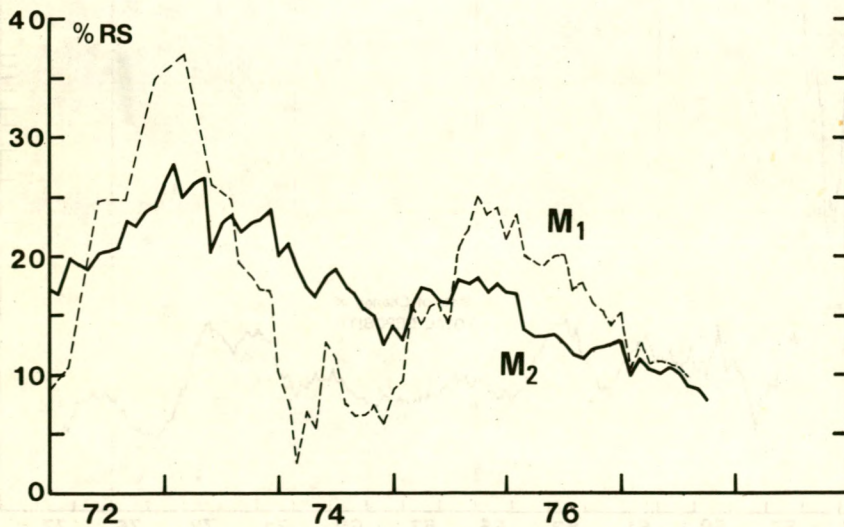
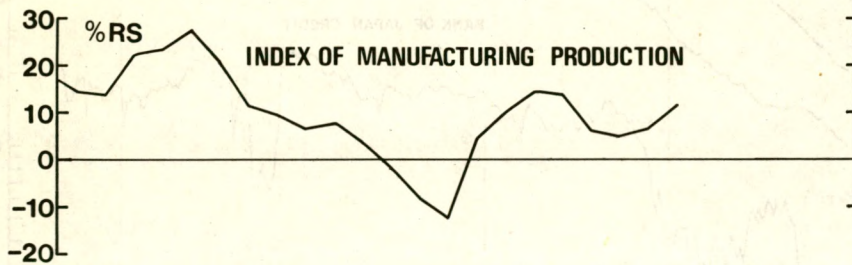
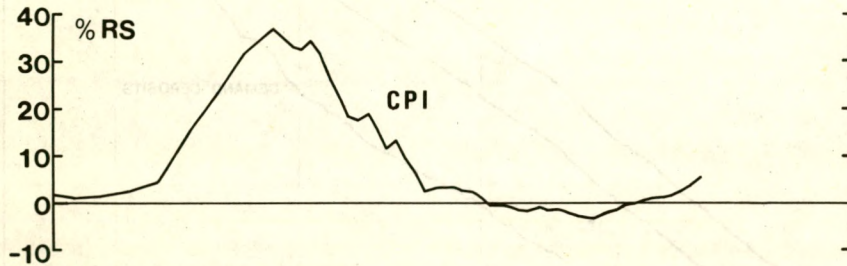
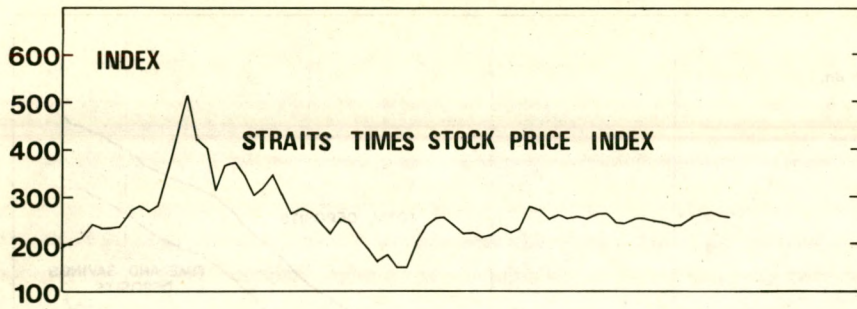
CHART 6 : BANK LIABILITIES



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SINGAPORE

CHART 1 : MONEY, OUTPUT, AND PRICES



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PARALLELS WITH HONG KONG AND JAPAN

In the period 1972-74 the experience of Singapore's economy and stock market was closely parallel to that of Hong Kong, but since the early part of this recovery the experience has in many ways more nearly resembled Japan than Hong Kong.

The similarity between developments in the banking sector in Singapore and Hong Kong from mid-1972 is really very striking. Chart 1 shows the sharp acceleration in money supply which occurred in late 1972, and how that surplus liquidity was reflected initially in a steep rise in equity prices, rising output, and ultimately in consumer prices. This conforms to the classical pattern of the lag in effect of changes in the money supply with the impact spreading from the securities markets, to output, and finally to consumer prices. Moreover this was precisely the pattern seen in Hong Kong. In the contractionary phase from mid-1973 the sequence was the same but the time lags were different: the impact on security prices was sudden while the impact on consumer prices was long-delayed.

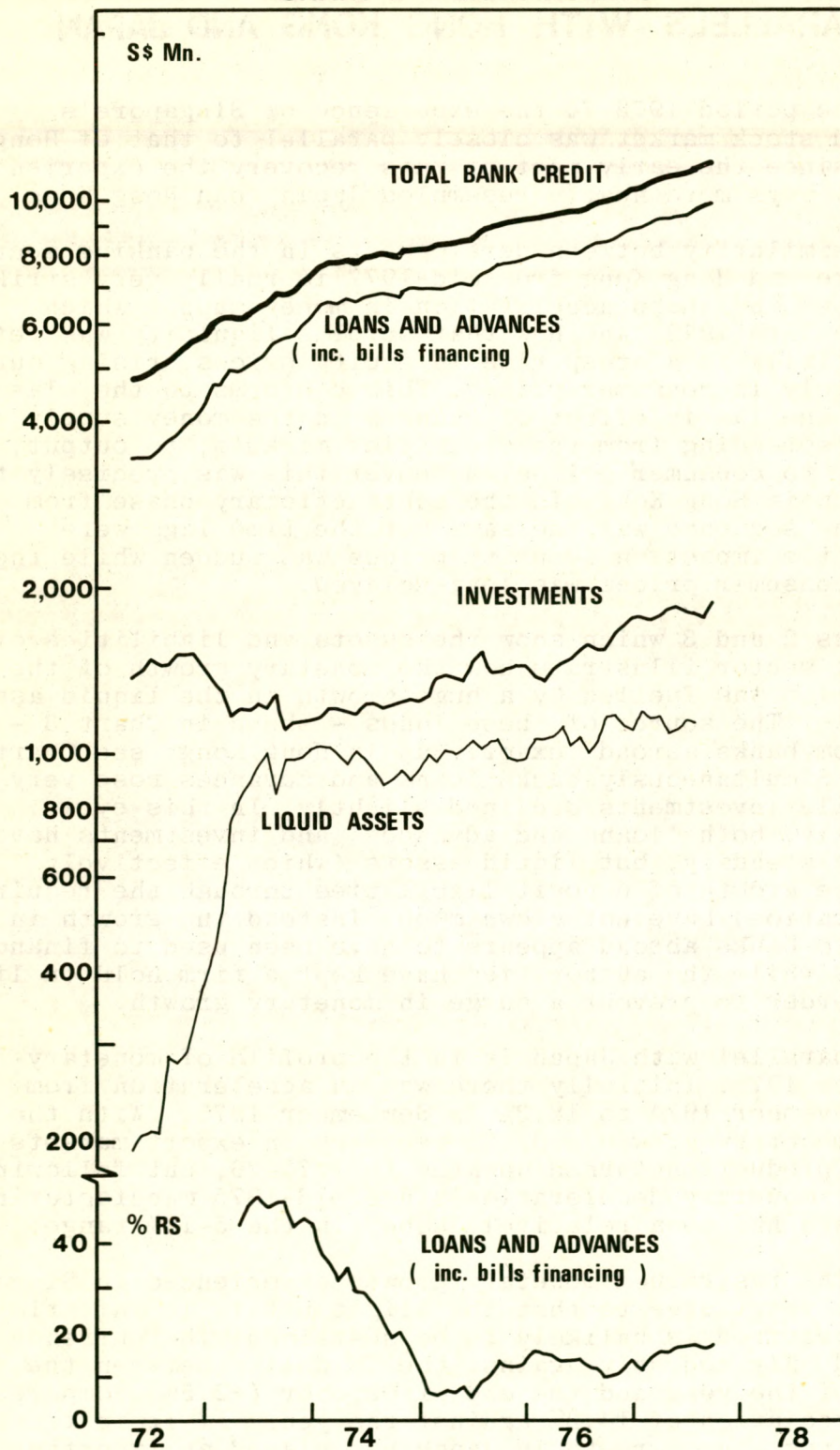
Charts 2 and 3 which show the assets and liabilities of the banking sector illustrate how the monetary growth of the 1972-73 period was fuelled by a huge growth in the liquid assets of the banks. The source of these funds - shown in Chart 3 - was clearly from banks abroad (exactly as in Hong Kong: see Chart 1 on p.10). Simultaneously banks' loans and advances rose very rapidly while investments declined slightly. In this cycle, contrastingly, both 'loans and advances' and investments have been rising steadily, but liquid assets (which effectively regulate the growth of deposit liabilities through the required liquidity ratios) have not grown much. Instead the growth in net balances to banks abroad appears to have been used to finance investments while the authorities have kept a firm hold on liquid assets in order to prevent a surge in monetary growth.

The parallel with Japan is in the profile of monetary growth since 1975. Initially there was an acceleration from 12.8% in November 1974 to 18.3% in September 1975. With the upturn in monetary growth and the recovery in export markets industrial production turned upwards in 1975-76, but following the gradual monetary deceleration since mid-1975 manufacturing output growth has been relatively sober in the 5-12% range.

FORECAST: The restrained monetary growth experienced in Singapore in the past year suggests that the slight upturn in inflation which has occurred is unlikely to be sustained. The currency had appreciated only modestly against the US dollar between the beginning of the year and the end of October (+2.5%) compared with a depreciation of 14.2% against the yen. If it is true that the restrained money growth in Japan has played an important role in the strength of the yen currency and the observation that Singaporean monetary behaviour has been similar to Japan's is also correct, this would suggest that the Singapore dollar could see some appreciation in the not too distant future.

SINGAPORE

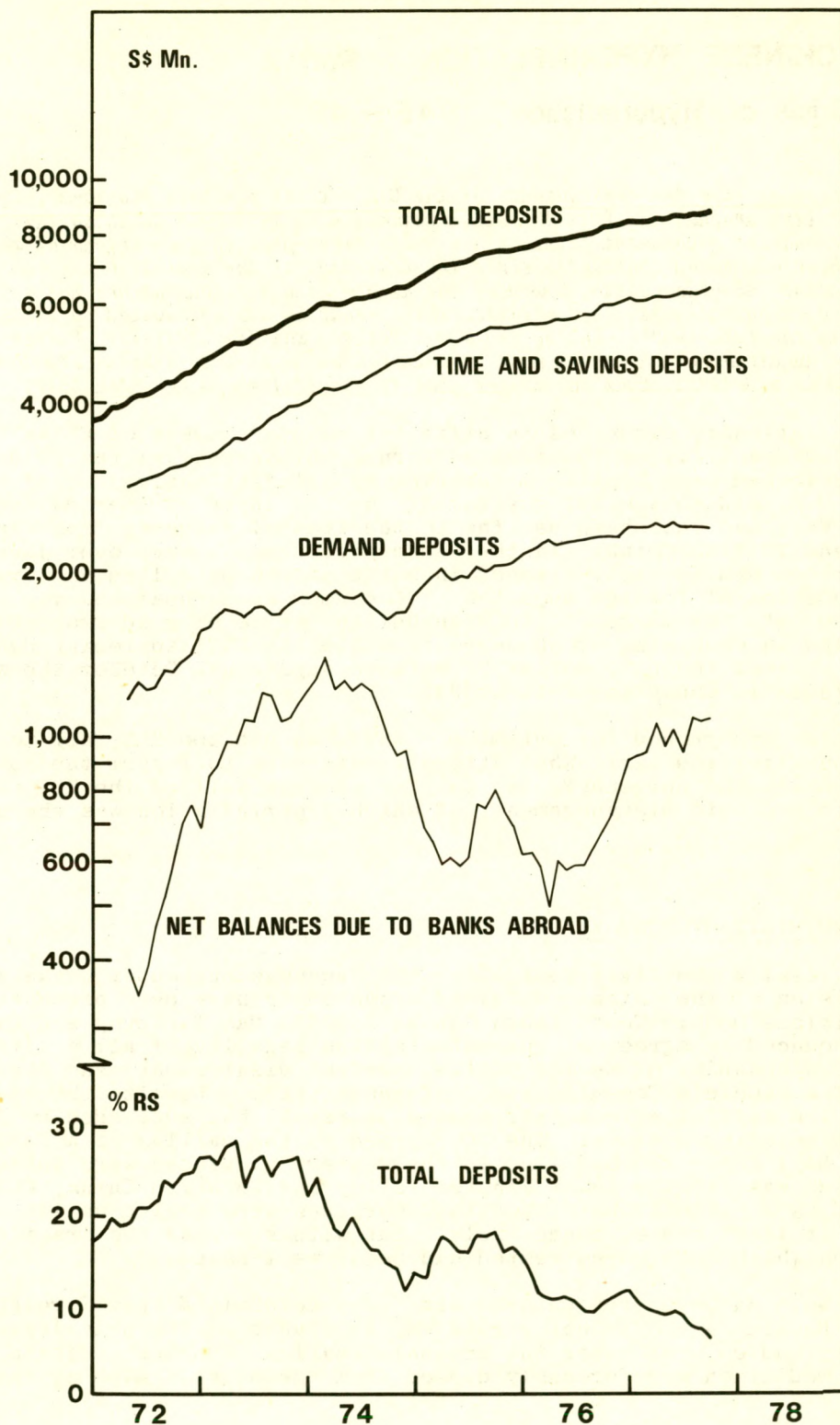
CHART 2 : BANK ASSETS



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SINGAPORE

CHART 3 : BANK LIABILITIES



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EPISODES FROM ASIAN MONETARY HISTORY

THE CHINESE HYPERINFLATION : Part 2

The Crisis of Hyperinflation, 1945 - 49.

Under pressure from the consequences of the U.S. silver purchase programme, China had 'reformed' its currency and left the silver standard in 1935. In doing so the Kuomintang-Nationalist government gained for a while great prestige, for reform of the currency had been advocated constantly since the last days of the Empire, but never tackled seriously. Simultaneously, however, the reform laid the foundations for an explosion of paper note issues. The inflation which resulted was aggravated by the Sino-Japanese war in the late 1930's, and by the wider Pacific War from 1941-45. Prices in Free China had accelerated throughout most of this period, with only a brief slowdown in late 1944, and in mid-1945. Even so, in the year to August 1945 prices rose 251%.

The inflationary processes in different monetary areas of China (see box on p. 2) did not follow the same patterns, but in general the price rise of 1942-45 had been kept from reaching hyperinflationary levels* by the flow of U.S. aid to the KMT government, by the entry of America into the Pacific War, and the sharp decline in the flow of refugees from Japanese-occupied areas to Free China. In the weeks preceding victory over Japan commodity prices had actually slumped in anticipation of allied victory and the resumption of foreign supplies. "Consumer goods hoarded over the years flooded onto the market....in Shanghai the price of gold dropped by 90 percent and in Chungking by 60 percent, while the CNC\$ appreciated by 100 percent against the U.S. dollar." Between August and October the wholesale price index in Chungking fell by 34%.

All this gave ground for optimism. Why then did the KMT fail to stop the inflation after the war? What attempts were made to reform the government finances and the currency? And how far was the fall of the KMT ultimately due to economic mismanagement, of which hyperinflation was the most glaring symptom?

POLITICAL AND MILITARY SUMMARY

Superficially the first year after the Japanese surrender began well. A fatal division of the Chinese mainland appeared to have been prevented. On the auspicious Double Tenth (10th October, 1945) Mao Tse-tung and Chiang Kai-shek announced an agreement guaranteeing the legality of all political parties, the disbanding of secret police, partial disarmament, and the convening of a People's Consultative Conference (PCC). Despite the near collapse of the initial agreements, General Marshall had succeeded by January 1946 in restoring a truce. The PCC agreed to the calling of a National Assembly in May; those who had fled to the Western provinces were joyfully migrating back east to the Lower Yangtze Valley and to North China; Chiang was welcomed as a national hero, and the Americans were hailed as liberators. A coalition at least seemed conceivable. But within a year the fragile agreements on which such hopes rested had been swept aside.

Since both camps on the Chinese side were determined that foreigners - American or Russian - should not regain any semblance of the privileged position they had enjoyed under the unequal treaties, American efforts attempts at mediation were probably doomed from the start. Also neither

* Hyperinflation has been defined as beginning in the month the rise in prices exceeds 50 percent, a condition not recorded in China until early 1947. (See Philip Cagan, "The Monetary Dynamics of Hyperinflation.")

MONETARY AREAS IN CHINA, 1935-49

There were at least seven major distinguishable currency areas in China during the years up to 1949. Fapi, or legal tender Chinese National Currency (CNC\$) circulated in the areas under control of the Nationalist government between 1935 and 1948, and was replaced by gold yuan and then silver yuan in the final debacle. Second, there were communist note issues circulating in areas controlled by the Red Army. Next there were three distinct areas where Japanese puppet currencies circulated. In Manchuria the Central Bank of Manchou issued currency which was redeemable at par or convertible into Japanese yen and was as stable as the yen. (Taiwan was in a similar position until 1945). In Japanese-occupied North China notes were issued by the Japanese Federal Reserve Banks, while in occupied South and Central China notes were issued by the Central Reserve Banks. Both the FRB and CRB areas had runaway inflation comparable to the fapi areas, and later worse. After the war FRB and CRB notes were redeemed by fapi (CNC\$) notes and the currency areas were amalgamated. Manchuria in the postwar period constituted a sixth separate currency area, but with the Russian invasion and a civil war in which both sides were printing money economic conditions were, if anything, worse than in the rest of China. Finally Taiwan's currency remained independent of the fapi, floating against the fapi and thereby enabling the island to escape the worst effects of the inflation which ravaged the mainland.

side was really interested in a united front when the main struggle was for domestic control. "One side intended to seize power, the other to retain it; one was determined to promote social revolution in the countryside, the other to prevent it." PCC agreements were steadily disavowed, armed clashes became more serious, and civil war was renewed. It was clear by the end of 1947 that the pretense at constitutionalism was a sham. The civil war of 1947-49 therefore sealed in military terms the failure of the KMT that had already been signalled in the political and economic spheres. A mammoth war spread over thousands of miles and involving millions of men on both sides, the campaigns began with Nationalist offensives to seize territory. These initial victories concealed the real deterioration that had occurred in KMT authority during the Japanese war, but by seizing large tracts of territory the Nationalists soon exposed their isolated garrisons to an exhausting guerilla-style warfare. Starting in Manchuria the communists scored a series of victories in a drive southward below the Yangtze River. By the end of 1947 the communists occupied Hopei and Shansi, and by the end of 1948 they had scored a decisive victory on the plains of the Hwai River near Suchow. In January 1949, the Nationalist commander, General Tu Yu-ming surrendered with the best part of the surviving Nationalist army. Chiang resigned the presidency and fled to Taiwan, resuming the presidency of the remnant of KMT-Nationalist China in March 1950.

Viewed retrospectively the illusions generated by early success probably contributed in significant measure to the failure of the KMT to reform. Because the true extent of the decay of the KMT and the range of the internal problems confronting China were under-estimated in the early postwar euphoria, a serious programme capable of finding broad support or competing effectively with the vision of Mao's "New Democracy" (1943) and the cheng-feng movement was never launched. But all this is to anticipate the story. Our task here is to analyse the process of decay in the KMT administration, the failure to reform the government finances, and the few last, desperate attempts at reform before the KMT were finally ousted.

BUREAUCRACY, CORRUPTION AND THE STATE COMPANIES

Victory over the Japanese in 1945 ought to have provided the Nationalist government with the opportunity to reform the national finances. Instead, the Kuomintang committed still more expenditure to the war against

the Communists. Yet unlike the struggle against the Japanese occupation, this cause attracted increasingly less sympathy. For in the immediate postwar years, the Chinese people suffered under a monumentally corrupt and inefficient government. The decay in the Kuomintang hierarchy was noted by Theodore H. White and Annalee Jacoby in 1946, formerly wartime reporters in Chungking. "The greatest indictment of these men is not their corruption, their petty tyrannies, their chicaneries: it is their sheer inability to govern - the last of the attributes to wither in any government group is its ability to loot, to oppress and to misgovern. In an atmosphere of seething inflation and of complete decay of morality, the money-hungry officials of Chungking returned to sack the cities and provinces they had liberated. With a feeling of nausea the people of Shanghai watched the government they had welcomed back sell licenses, sell privileges, mismanage foreign relief supplies, condone hoarding. They watched the printing presses spin off reel after reel of worthless money, while prices soared and bureaucrats danced at night clubs and drank at fine hotels."

The reference to bureaucrats is not merely emotive. Postwar government in Nationalist China was exercised predominantly in the interests of the Party elite. This was noted in a U.K. trade mission report: "Government monopoly in China in many of its forms is an entirely different kind of monopoly from government monopoly in Great Britain: rarely does it involve socialisation of production or services, but tends rather to politico-bureaucratic control."

At the top of the hierarchy, a small group of powerful families monopolised the country's wealth. All the important mines, factories, financial institutions and communications were in the hands of the governing few. Large state companies, such as the Central Trust and the China Silk Corporation, were able to enjoy unfair advantages over their competitors in the private sector. This discrimination was exercised in several ways:

i) State companies could act as purchasing agents for private concerns within China since they did not have to meet the licensing, foreign exchange or quota requirements that were pushing the legitimate importers to the wall. Moreover, many of the goods which these state monopolies bought for importing would have been denied entry if the purchase had been made by another company, especially if it was foreign-owned. The discriminatory policy is well illustrated by a contemporary story from the Far East Economic Review: "A firm representing cadillac in China has been unable to obtain import permits because the price exceeds the \$1,200 limit set by the import restrictions. Yet a recent shipment by Central Trust of China included 23 cadillacs." With the one hand, the Chinese authorities were allowing a privileged few to profit in a trade of scarce and officially prohibited luxuries. With the other, they were preventing the inflow of essential raw materials and spare parts desperately needed to build up industrial production, on the grounds that foreign payments had to be balanced. This conflict in policies represents an unholy marriage between actively discriminatory measures and misguided regulations, having the opposite effect to what was intended. In inflation-ridden China, it was imperative that the output of goods increased to meet the frantic levels of demand.

ii) The state companies, otherwise known as "the Holy Family", profited when the government introduced policies aimed at encouraging industrial expansion. They were the first to receive low interest loans or to be allocated foreign exchange. Such decisions were seldom made on purely economic criteria.

iii) Since they enjoyed the favour of the government, the large monopolistic concerns could also convince foreign manufacturers that they were essential intermediaries for any business conducted within China. By their self-promotion abroad they acquired the function of sole purchasing agencies. In March 1947, the Central Trust sent the following circular to American manufacturers: "Please be advised that we are the authorised purchasing agent for government offices and commercial firms." Never was the arrogance

of a monopoly more clearly expressed.

The 'corrupt and swollen public sector in nationalist China is crucial. It explains the small businessman's lack of sympathy for the Kuomintang, and his relative apathy towards the increasing likelihood of a Communist victory. It also reveals the dilemmas of American policy. For China under Chiang Kai-shek was no monument to free enterprise. This was clearly expressed in the Far East Economic Review in an article of February, 1948. "It is ironical that the U.S.A., which is now the main citadel of private enterprise in an increasingly collectivist world, should have pursued policies in China which have served to strengthen and entrench the Chinese economic bureaucracy and thus still further block the recovery of Chinese private business."

Corruption also grew at the bottom of the Kuomintang hierarchy in the postwar period. With inflation destroying the real value of salaries, government officials exploited their position to reap financial gains. This was facilitated by the Nanking government's loss of central control. Tax collectors used confiscatory practices on those least able to defend themselves. With the flood of government regulations, public officials also acted increasingly in the role of economic police. This provided further opportunities for the arbitrary seizure of goods. "It is particularly those bureaucrats who have acquired power only recently," one observer of the spreading decay noted, "who are all out opportunistic and regard their office as the best and quickest means to dispossess others and enrich themselves."

THE COURSE OF THE INFLATIONARY SPIRAL

The main causes of the resumption of the rise in prices, despite the defeat of the Japanese, are clear. First, the government deficit continued to grow, financed by monetary expansion. In the early postwar period government tax revenues were supplemented from the proceeds of selling gold, foreign exchange, and captured enemy property. But with a 3.2-fold jump in government expenditure in 1946 the gap between government revenue expenditure quadrupled, widening thereafter by leaps and bounds.

(CNC\$ billion)	Government Revenue	Government Expenditure	Government Deficit	Note Issue
1945	1,241	2,348	1,106	1,031
1946	2,876	7,574	4,697	3,726
1947	14,064	43,393	29,329	33,188
1948	220,905	655,471	434,565	374,762

The deficit was necessary, according to the Nationalist government, in order to maintain sufficient military strength to contain Communist expansion in Manchuria and North China, and to finance the rehabilitation of the economy in previously occupied areas. Military outlays ranged from 55 percent of total expenditure in 1947 to over 64 percent in 1948, but another serious drain on revenues was a swelling bureaucracy whose wages and salaries were linked to the cost of living index. As prices began to rise faster than the rate of growth of the money supply these rising commitments forced the authorities to depend even more on direct borrowing from the Central Bank. The table below neatly encapsulates the financial problem of the postwar years.

Postwar Government Expenditure (1946-July, 1948)

(CNC \$ billion)

Postwar government expenditure	708,787
Taxes and other revenue	237,256
Borrowing from non-bank sources (Noninflationary borrowing)	590
Residual debt monetized (Inflationary borrowing)	469,717



THE CUSTOMS GOLD UNIT

Since China's foreign debts were expressed in terms of foreign currencies, any depreciation in the value of Chinese currency (or silver before 1935) increased the real burden of debt. Thus between 1925 and 1929 when the price of silver declined relative to gold, the external debt burden climbed proportionately. Although Chinese authorities fortunately rejected American advice contained in the Kemmerer Report to adopt a gold standard in 1930, an order was implemented to establish the CGU - customs gold unit - requiring import duties to be paid in the new unit. At first the CGU was made equivalent to the gold value of US\$0.40 (60.1866 centigrams) so that after Britain and the U.S. left the gold standard (in September 1931 and March 1934 respectively), the depreciation of the pound and the dollar meant that less gold had to be paid for the same foreign currency debt. Throughout the period of sharp silver price movements in the early 1930's China's customs revenues were therefore stabilised, remaining largely unaffected by the silver problem.

From October 1939 the CGU was pegged to the CNC\$ (or fapi) and as a

result lost its special monetary characteristics; on the new basis one CGU was exactly equivalent to 20 fapi or US\$1.00. In the early days the authorities made use of the association in the minds of the Chinese public between the gold metal and the CGU to issue war bonds denominated in CGU rather than CNC\$, and for a time the American-printed CGU 1000 notes proved to be more popular than the fapi, commanding a premium in exchange for puppet Central Reserve bank notes. The primary function of the CGU in the postwar period was as a parallel legal tender. The CGU 25,000 note illustrated was not only equivalent to CNC\$500,000, but was also referred to as such in common speech. This must have been frustrating to the authorities because one reason for the change to CGU in lieu of fapi was that the smaller face values would mask the degree of inflation. For example, in 1947 when the Central Bank issued its first CNC\$10,000 note there was panic in the Shanghai money market, but simultaneous issue of the CGU 10,000 (worth CNC\$200,000) provoked little comment. In fact the only conspicuous effect was to add to the complications of handling huge sums in everyday transactions by requiring face values to be multiplied by 20. The largest CGU denomination note put in circulation just before the currency reform of 1948 was CGU 250,000 equivalent to CNC\$5,000,000. By this time there was no gold backing, the need for a special customs unit of account had vanished, and the CGU survived as a monetary device capable of deceiving only the simplest minds that China retained any semblance of a sound currency.

The second cause of the renewed rise in prices came from the removal of Japanese puppet currencies from the monetary system. Far from relieving inflation merely their removal served to intensify the inflationary pressure. The reason was that although 4 months were allowed for the conversion of puppet currencies into Chinese National Currency, there was a limit of CNC\$50,000 that could be converted. However, because the currencies were undervalued in terms of the CNC\$, those holding puppet currencies tried to reduce their holdings by spending, thus further increasing the velocity of circulation. This led to an increased demand for goods purchaseable with the undervalued currencies, especially with the upper limit on the amount convertible into the CNC\$.

Third, the pent-up demand for consumer goods associated with the end of the war led to a growing volume of imports into the eastern coastal area. Poor communications and the primitive infrastructure prevented these goods being supplied from the internal region where industry had been built up during the war. The flow of capital from the interior to liberated Shanghai added to the demand pressure in the coastal area, reflected in the distinctly more rapid rise in Shanghai's price index in comparison to Chungking's.

Fourth, price inflation was intensified by the increase in velocity. Between the end of 1946 and April 1947, for example, the note issue increased 1.72 times, but prices rose 3.5 times over the same four month period. The government's refusal to reveal the amount of money being printed further undermined people's confidence. (Statistics quoted here and elsewhere were collected and published by Central Bank staff some time after the fall of the Nationalist regime on the mainland.) Despite the endless pious statements that the budget would be balanced, public scepticism intensified. The more official statements distorted the observable facts, the more the public ignored the numerous controls and turned to "illegal" means in an attempt to preserve their savings. Black markets in essential commodities, gold and foreign exchange thrived. This created the opportunity for enterprising merchants to keep one step ahead of the inflationary spiral. It was the poor and the salaried professional classes who suffered the most.

ATTEMPTS TO SUPPRESS INFLATION

When inflation began to accelerate again following the brief postwar lull, a barrage of price and wage controls was introduced, starting in February 1947. When these measures had been introduced during the war they had failed disastrously: this time prices were rising twice as rapidly, doubling every two or three months. Nevertheless an emergency order of February 16, 1947 placed price ceilings on rice and flour, cotton yarn and cloth, oil, salt, sugar etc., imposed a mandatory wage freeze, required employers to allocate daily necessities to employees, and prohibited the hoarding, buying, or selling of gold and foreign currencies. By mid-April black markets had mushroomed, the regulations were openly flouted, and the authorities were obliged to back down, unfreezing wages in May. Wholesale prices, which had risen 19 percent in January before the freeze, jumped 54 percent in May.

The controls, the inability of the authorities to enforce them with any uniformity, and the increasing distortions to which they gave rise did much to alienate what popular following Chiang Kai-shek had recovered at the end of the Japanese war. "Under such conditions," lamented the Far East Economic Review in April 1947, "it is questionable whether economic research work is of any use in present-day China. Let the man-made typhoon wreak its havoc, and when the national barometer indicates the eventual passing of this great affliction of the Chinese people, a new period of cooperation between the world and China can be inaugurated." But the inflation still had two years to run. In August 1947 the new loans of the government banks were restricted to just five groups of essential industries, and in December the government banks were prohibited from lending to private banks. Interest rates were pegged and severe penalties laid down for infringement. To control capital movements and regulate the money market a Banking Control Bureau was instituted, its officials being empowered to inspect the books, records and correspondence of banks, firms and individuals, search without warrant, and generally investigate anybody's financial dealings. Coercion, in short, replaced indirect control. In January 1948 and coinciding with the traditional Chinese New Year - normally a period of tightness in the money markets due to the Chinese habit of settling all outstanding debts at this time - the Generalissimo decided to intervene personally. A total ban on all new credit extensions was enforced, throwing the money markets into confusion and obstructing bona fide commercial transactions. For three months the government persisted with the ban, and as a result the rate of price increase eased slightly. However, since the budget deficit was constantly putting new money into the hands of the public, controls on bank credit failed to restrict the growth of the money supply: the ratio of cash currency to deposits rose even more rapidly as did the note issue.

In March 1948, the Far East Economic Review reported,

"Whenever there are great upheavals in the financial and commercial markets of China, the rather helpless working authorities know nothing better than to call out secret service agents, gendarmes or special police organs." Contempt for the Kuomintang policies appears again in an article two months later. "Inflation is robbery. Ever more trillions of national money are pouring from the printing presses but the Government insists on a 'low cost policy', on the freezing of salaries and on the arrests, legal or extra-legal, of such people who want to invest their savings in stable and value-maintaining gold and foreign currencies."

The proliferation of regulations and public confusion as to what was permitted of not permitted is evident from contemporary accounts. In July 1948, for example, an order was promulgated rescinding the ban on the movement of bank notes and funds between cities - itself a typical example of a decree aimed at the symptoms rather than the causes. When many local

authorities ignored the revocation, higher officials stepped in. "Confiscations, authorised or unauthorised, continue, and the victims, usually small people, do not know whether they have been robbed or only penalised for having broken one of the innumerable regulations of the innumerable authorities."

Meanwhile, half-baked schemes continued to be devised by frantic officials. One example was the recommended selling of government-owned properties with the aim of building up the currency reserve fund. No one actually looked into the sordid details of who would actually buy these properties, and at what price. Another advocated a loan from the U.K. and the U.S.A., backed by a silver standard. Previously issued money would be recalled, while the debtors would promise that no more paper money would be issued. All such schemes ignored the central issue, namely the balancing of the budget.

Inevitably the government's deceit was matched by the people's growing awareness of what was actually happening. The Far East Economic Review contained the following report from Shanghai in July, 1948: "Every major crisis in Shanghai produces hackneyed accusations against the unholy trinity of speculators, manipulators and hoarders,..... At the same time inspired stories about the currency stabilisation of the CNC\$, the introduction of a new legal tender and extravagant new help from the much abused America, are unleashed and cause some spells of perplexion and confusion. But after a little logical thinking the city regains its old and oft-proved scepticism, and the result is shown in the gold, foreign exchange and commodity prices quoted on the black markets."

"ANTI-FOREIGN"

One of the Kuomintang's standard expedients was to arouse anti-foreign sentiments. It was only by finding such scapegoats that they could temporarily divert the people's attention away from their own incompetence. One such target was Hong Kong. An official announcement stated: "The national emergency calls for the speeding up of the negotiations with the Hong Kong government to halt the circulation and manipulation of the CNC\$". As a free market with a stable currency, Hong Kong attracted funds in an inverse relation to the financial debacle in China, but this was hardly the fault of the Colony. A contemporary journalist pointed out the irony; "The Colony - not Nanking - is called upon to 'act'. It is impossible to comment seriously on this matter."

Envious eyes were also cast at Japan, especially since she was prospering despite her recent crushing defeat. Insult was added to injury by the growing amount of American aid given to Japan in sharp contrast to China. An article of June 1948 described the growing success story: "The national genius of the Japanese people, if controlled for the time being by the U.S.A. for the sole purpose of ensuring democracy and peaceful development in the country, may prove of very great benefit for the nations in the Far East which are living and producing on an inferior level." Americans themselves were increasingly the target of criticism within China. This led some businessmen to sponsor a "Get the Hell out of China Club." The U.S.A. herself became a chief target of attack amongst both sets of partisans in the domestic strife. This was despite General Marshall's attempts to mediate between the two sides after the victory over the Japan, and so prevent the outbreak of civil war. A New Statesman article put the matter succinctly: "There is much confusion about American policy. The Kuomintang wonders why the American government holds up the promised loan which they need to destroy the Communists. The Communists are certain that the Americans are backing the Kuomintang. An interest in peace would surprise both parties."

Perhaps the wisest words were written by the historian, J.K. Fairbank in November 1946. In discussing what American policy should be in the postwar period, he put the matter firmly in perspective. "We cannot erase

communism from the Chinese political scene, however many tanks and planes we give to Chiang. If we oppose the revolution blindly we shall find ourselves eventually expelled from Asia by a mass movement."

COLLAPSE OF THE MONEY MARKETS

With the development of the hyperinflation the monetary system suffered a complete breakdown. By 1947 in Shanghai the demand for notes was exceeding the capacity of the printing presses to produce. To compensate, the habit grew of writing checks on anticipated bank deposits which had not yet materialised. The growing use of checks, the acceleration of velocity, and the decline in the real value of deposit money balances are shown in the table below.

Shanghai Money Market

	<u>Cheques Cleared</u>			<u>Private Bank Deposits</u>			
	Number (000)	Amount (CNC\$ billion)	Ratio of Amount to Note Issue	Velocity of Circu- lation of Currency (1)	Velocity of Circu- lation of Deposit Currency (2)	Current Value (bn.)	Real Value at Prewar Prices (mm.)
1946							
July	1,702.2	3,751.1	1.78	2.52	38	100.4	27.0
Dec.	2,231.2	8,124.0	2.18	2.57	36	237	41.5
1947							
July	3,041.0	38,067.8	2.82	4.18	42	714.5	23.8
Dec.	4,921.0	120,813.0	3.64	5.27	56	2,419.3	28.8
1948							
May	6,712.7	732,042.0	5.33	5.56	80	11,247.4	20.7
June	5,239.3	848,306.6	4.31	7.00	82	12,801.7	6.5
July	6,705.1	1,969,536.7	5.25	10.82	90	24,373.4	8.5

(1) Derived by dividing the wholesale price index of Shanghai by an index of note issue. Cheque transactions impair but do not wholly invalidate these indications.

(2) Derived by dividing total clearings by total current deposits.

These data provide the technical evidence of monetary disintegration, but on a more mundane level evidence abounded. Newspapers would not accept subscriptions for more than a month due to the escalating price levels, local provincial authorities insisted on payments in kind and resorted to barter among themselves, while businesses and government organisations alike attempted to buy commodities in advance of production. Commodity and future markets took over from money markets at every level as private individuals and government agencies tried to offload their worthless money balances.

"At the end of May 1948 a new cabinet was organised, and the Minister of Finance and the Governor of the Central Bank of China were replaced. Open inflation continued. In June and July, Shanghai wholesale prices increased by 260 percent and 45 percent, respectively, and the market rate of foreign exchange rose by 98 percent and 181 percent, respectively. The black-market price of gold trebled, and the supply of currency in circulation doubled during each of those months. These frightening presages of monetary collapse forced the government into the abortive monetary reforms of August 1948."

THE "GOLD YUAN" CURRENCY REFORM

On the 22nd of August, 1948, Chiang Kai-shek announced an official reform of the currency. In doing so, he revealed his government's continued failure to appreciate what the main priorities of policy should be, when he commented on "the usefulness of the CNC\$" through which "during ten years we have financed wars and reconstructions." Little attention appears

to have been paid to the large-scale expropriation of the people's wealth - that occurred during that same period.

Under the terms of the reform, a "Gold Yuan" was created to the value of CNC\$3,000,000, to be maintained against a 40% reserve of gold, silver and foreign exchange. Prices were frozen, and all private holdings of gold, silver and foreign exchange were to be surrendered within 3 months. These controls were to be enforced by a host of officials. Initially, the policy was successful. Intimidated by the naked coercion of the government, the public submitted to the regulations. In particular, the "Generalissimo's son exerted an iron control over the major hotbed of speculation, Shanghai. Success was shown by the US\$170 million worth of gold, silver and foreign exchange that was surrendered to the Bank.

However, by implementing the policy, the authorities forfeited the respect of the lingering few who had not already abandoned their wider sense of social responsibility through the demands of self-interest imposed by inflation. Chang Kia-ngau summed up the arbitrariness of the measures in an emotive yet fair manner: "When finally the government, under the pretense of currency reform, compelled the surrender of precious metals and foreign exchange at rates resembling outright confiscation, it in effect committed moral suicide because of the manifest injustice done to patriotic and law-abiding citizens, as contrasted to those who previously had removed their capital to foreign lands."

The artificiality of the controls could not be disguised for long. Contemporary scepticism was evident from the beginning. The Washington Post editorialised: "It is evident that China has put up a new facade with a view to trying to attract money that the U.S.A. allotted for aid to China for a purpose never contemplated, namely the balancing of the Chinese government's budget.....All that can be expected, and all that the Chinese themselves expect, is a currency usable for a while."

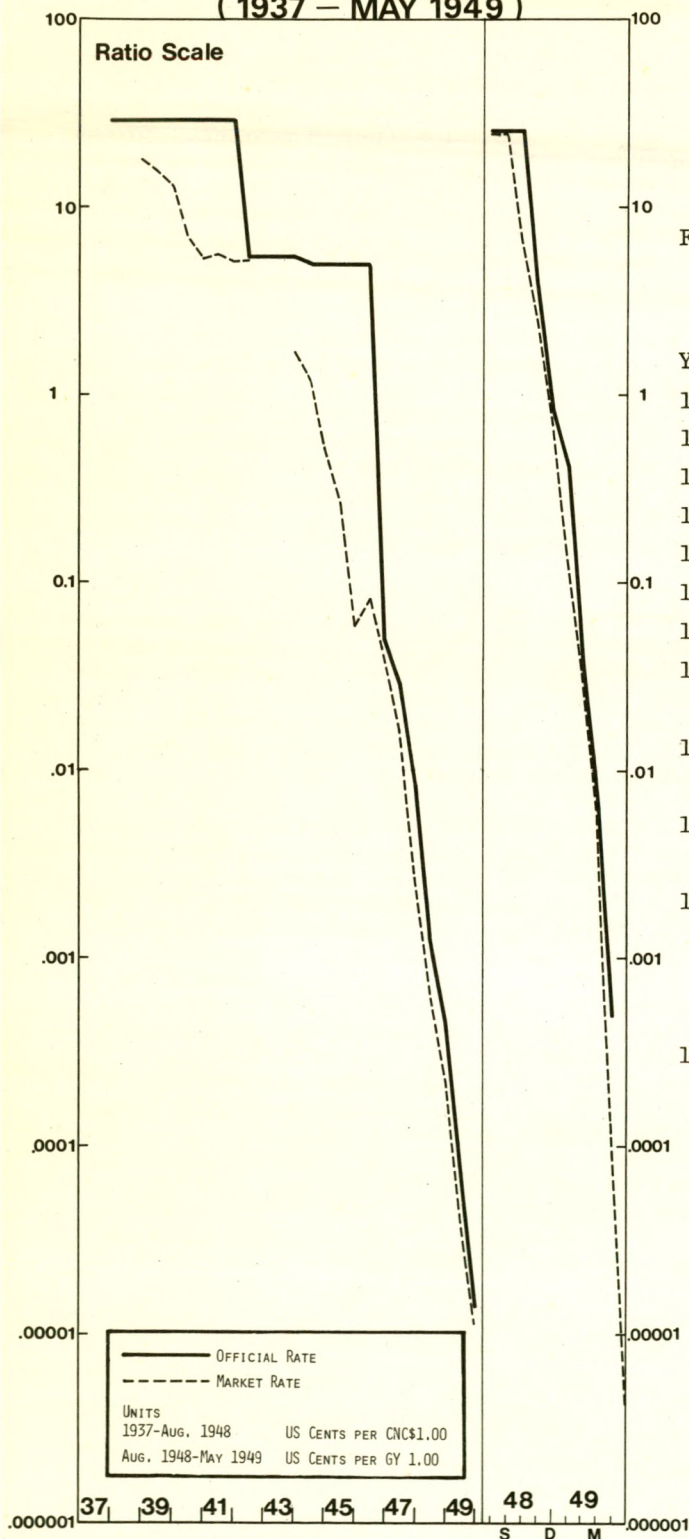
The Shanghai economist, Eduard Kann, pointed out a serious defect of the reform: "Not enough emphasis has been laid upon one of the principal positive factors, to wit, the need for much enhanced Chinese production." Only by increasing the output of goods, especially essential commodities, would the Government restore the confidence of the people and with it the value of the currency. Punitive and confiscatory measures, however apparently effective in the short-term, would only have an adverse effect. In this respect, the currency reform did not help because the increased control of imports merely stopped the inflow of raw materials which were vital if industrial production was to be stepped up, and the forceful exchange of precious metals and foreign exchange increased the volume of banknotes on the market. This surplus money both stimulated demand, and provided cash for the purchase of commodities and other speculation. Funds were also transported out of the country, as the Central Bank's "Financial Daily" reported on October 10th: "Hong Kong has become a temporary 'resort' for the idle capital which took flight to South China from the various points in the country. From Shanghai alone it is estimated that some GY 100 million were sent to South China during the past week. Most of these idle funds were turned into foreign currencies, resulting in a drastic increase in the black market exchange rate for U.S. dollars and H.K. dollars in the Colony. The depressed Hong Kong market has assumed a monetary boom."

The breakdown of the currency reform is clear from the growing symptoms of disorder. Buying sprees were prevalent while black markets mushroomed. The Communists pursued "economic warfare" by purchasing gold and silver with Nationalist currency at high prices in a successful attempt to reduce the Central Bank's bullion reserves. In October, the chairman of the Shanghai sugar guild was arrested when the sugar supplies suddenly disappeared from the market, while customs officials increasingly charged duty at black market rather than official prices. Also gold was smuggled in from Macao, and sold at market rates irrespective of the price fixed by the IMF.

(continued on P. 44)

CHINA

OFFICIAL AND MARKET EXCHANGE RATES (1937 - MAY 1949)



Foreign Exchange Rate: 1937-Aug.1948

Year	U.S. cents per CNC \$1.00	
	Official	Market
1937 Dec.	29.2500	-
1938 Dec.	-	15.6250
1939 Dec.	-	6.9115
1940 Dec.	-	5.63280
1941 Dec.	5.3125	5.28125
1942 Dec.	5.3125	-
1943 Dec.	5.0	1.191
1944 June	5.0	0.521
Dec.	5.0	0.1753
1945 June	5.0	0.0586
Dec.	5.0	0.08165
1946 June	0.0495	0.0375
Dec.	0.02884	0.0165
1947 March	0.00834	0.00714
June	0.00834	0.002715
Sept.	0.00240	0.00199
Dec.	0.001288	0.000668
1948 March	0.000474	0.000222
June	0.0000785	0.0000433
Aug.	0.0000141	0.0000115

Source: CHANG KIA-NGAU

* * *

THE FOREIGN EXCHANGE MARKET IN POSTWAR CHINA

The postwar period in the foreign exchange market may be conveniently divided into three: a period of fixed rates combined with trade and capital controls to August 1947, a period of partially floating rates to August 1948, and finally a brief attempt to hold the floodgates before new issues of gold yuan precipitated a man-made typhoon.

At the end of the war Shanghai was reinstated as the international trade and banking centre of China. American loans and the confiscation of enemy properties provided the Central Bank with US\$858 million in gold, silver, and foreign exchange, an unprecedented reserve with which to manage the foreign exchange market. But very soon it became evident that these resources were inadequate to cope with the flight of capital and the enormous demand for imports. Direct controls were therefore imposed on imports, while capital movements were subject to increasingly dire penalties. Even so by February 1947 half the foreign exchange reserves had been used up on imports and in defending the fixed rate. Emergency regulations published in the same month prohibited free market transactions and restricted the free flow of capital to Hong Kong. Nevertheless the drain continued.

From August 1947 an attempt was made through a Stabilisation Fund and an impartial committee to operate what we today would call a "crawling peg". The committee used average wholesale prices from different cities in China as reference indices as well as the free market rate in Hong Kong to set the intervention rate for the Fund. Before long the committee was accused of chasing the black market rate and thereby causing prices to rise. The crawling peg at least had the advantage of reducing the drain on official reserves, but the widening gap between committee rates and market rates hastened its own demise. When the committee began operations the rate was set at CNC\$38,636 to US\$1.00 quite close to the market rate of CNC\$42,759; when the system was altered in May 1948 the committee rate had risen to CNC\$399,000 while the market rate had climbed to CNC\$1,167,154. Between May and August 1948 an abortive certificate system operated, the details of which are not important - suffice it to say that the new official rate rose from CNC\$849,000 per U.S. dollar on June 2nd to CNC\$7,850,000 on August 19th, two and a half months later.

The third and final phase in the foreign exchange market was a fixed rate regime which gradually gave way to another system of clearance certificates. The Gold Yuan, announced on August 20, 1948, was fixed at GY 4 per US\$1.00, and the authorities managed to hold this rate for two months. By the end of October the rate had risen to GY 15, and by yearend it was GY 135. Thereafter it was like a typhoon:

Market Rate for GY per US\$ in 1949

January	700
February	2,980
March	17,700
April	813,880
May (up to 21st)	23,280,000

"According to the market rate at the beginning of May, US\$1 was worth 9 million Gold Yuan. Converted into old currency, this would equal CNC\$27,000 billion. This was two and a quarter million times higher than the rate of the old currency just before Gold Yuan was issued. Late in May, when the Communist army approached Shanghai, the market was in a panic. US\$1 was worth 23 million Gold Yuan. Everybody was scrambling for foreign currency rather than holding commodities. Finally, the exchange rate of Gold Yuan disappeared after the fall of Shanghai." (Chang Kia-NGau)

The Gold Yuan was literally worthless.

* * *

(Continued from P. 41)

On November 11th, 1948, the Government admitted defeat, and the GY was devalued by 80%. An article in the Far East Economic Review shows the contemporary lack of concern for the Nationalist's predicament: "The people have clearly indicated to the high and mighty Kuomintang rulers that they have the courage and the means to defeat any state controls and interference, even if backed up by terror, secret police and concentration camps a la Himmler."

Devaluation was accompanied by a new expedient. In an effort to make the new currency more attractive, the GY was declared freely convertible into gold. Soon, the danger of the complete loss of the gold reserves became apparent. The Government's response was to require official approval before the notes could be converted. The result was riots in Shanghai on the day of the issue of application forms. Several people were killed, and chaos continued, while the expansion of the new currency accelerated out of control (see Chart on p.

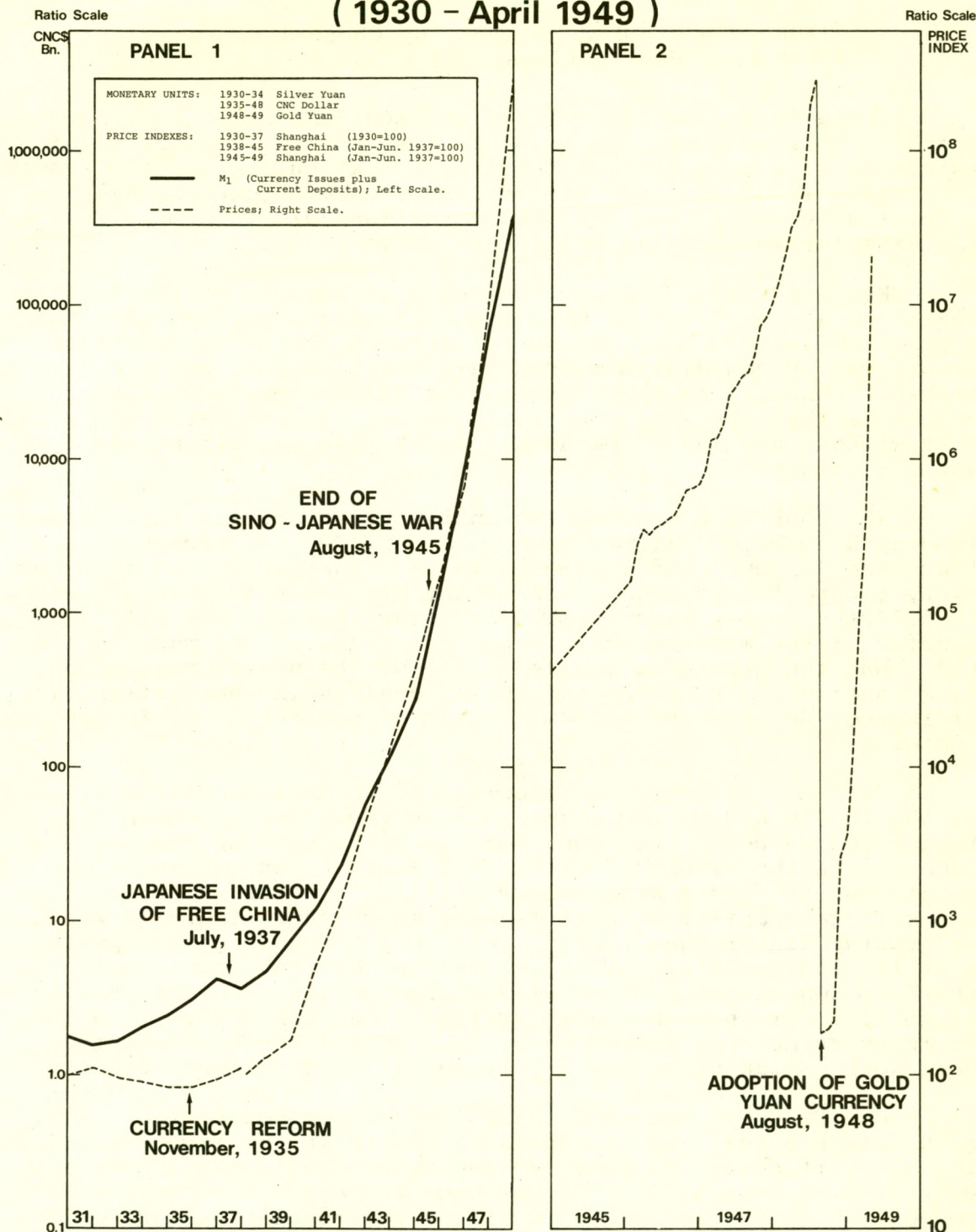
It is interesting to contrast the "Gold Yuan" episode with the contemporary German currency reform of June 1948. In the German case, the new currency was not based on metal or foreign exchange. The principal aim was to keep the supply of money scarce, so that there was no spare cash to stimulate speculation and the growth of black markets. Instead, efforts were centred on increasing production. The money supply would only expand along with the growth in the output of goods. The German success contrasts markedly with the Chinese experience.

Following the surrender to the communists of General Tu Yu-ming in January 1949, Chiang Kai-shek resigned in February, and fled with the last of the gold reserves (about 3 million ounces) to Taiwan. In the same month a final attempt was made to restore a silver dollar standard, but those reserves too were soon depleted. The last-ditch restoration of the silver standard marks the full circle in Nationalist policies pursued since 1935. Having abandoned a self-adjusting silver standard initially under the force of external pressures, the regime had turned to an essentially discretionary paper standard. But lacking the political authority to raise sufficient tax revenue, expediency gradually became the greater part of discretion, and a plethora of controls was substituted for the free market forces which had served China so well in the years of the Great Depression.

The preference for authoritarian controls was characteristic of the whole Nationalist approach to government. This prejudice was reflected in Chiang Kai-shek himself, and in China's warlord past. Yet it is facile to place the blame on one man alone, and to paint the Generalissimo as the supreme villain of the piece. Chiang's weakness lay in the nature of the Kuomintang, a coalition of interests. In order to pursue his military campaigns, the civilian side of the Party bureaucracy had to be rewarded. This explains the discriminatory policy favouring the publicly owned firms, and the control of a few families over the whole economy.

Fairbank has written a reasoned judgement on the Kuomintang leader: "Chiang Kai-shek, who took responsibility as the holder of power, has been by many assigned responsibility for losing it. Study may show, however, that he was seldom the master of Free China's circumstances; his cause was damaged less by inadequacies of virtue than by an excess of virtues that were out of date, less by initial corruption among his followers than by a disregard for economics. This inflexible rectitude mirrored the inertia of a whole political tradition, still in the shadow of the Confucian monarchy."

MONEY SUPPLY AND PRICES IN CHINA (1930 - April 1949)



Source: Chang Kia-NGau, "The Inflationary Spiral"

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NEW BOOKS

"THE ECONOMY OF HONG KONG" by Cheng Tong Yung
Far East Publications, HK\$39.50

Cheng Tong Yung has written an excellent basic text-book on the Hong Kong economy. He examines systematically every major aspect of Hong Kong activity giving a clear outline of the economic principles involved. Not only do the economic concepts help in understanding Hong Kong, but also Hong Kong provides many fascinating examples which bring the theory alive.

Being a small economy, Hong Kong is ideally suited to this text-book approach. Hong Kong has a simpler structure than more highly developed countries and illustrates raw economic forces unobscured by convoluted taxes, barriers to trade, price controls, exchange controls or large government fiscal imbalances. The result is that the simple economic theory is applicable and plausible without needing to be hedged about with exceptions and qualifications.

The book is a mine of fascinating statistics. For instance, in Hong Kong 29,000 firms are born and 27,000 die each year and there are 182,000 establishments in all; that makes one firm for every twenty-two persons - one of the highest ratios in the world. In 1974 the hourly wage in manufacturing industry was only a quarter of the wage in Britain and an eighth of the wage in the U.S., but the growth in real earnings of the poorer groups in Hong Kong is rapidly reducing the inequality in the distribution of income, despite the minimal degree of progressivity in the tax system.

The rate of growth of exports has shown a secular decline in the 1970's and in the chapter on overseas trade, Cheng Tong Yung cites evidence that Hong Kong products have become less competitive than those of Taiwan and South Korea. However, he points out that Hong Kong is now shifting towards the production of skill and capital-intensive goods whose share in world trade is growing faster than that of Hong Kong's traditional exports - textiles and clothing. This is just one of many indications that the Hong Kong economy is maturing. Per capita income is now only slightly lower than in Italy and the increasing diversification of industry and the expansion of the services sector show that Hong Kong is taking on the attributes of a 'developed' economy.

But Dr Cheng believes the government is not keeping pace, with this process. While generally moving in the right direction, too often it drags its feet and the government comes in for sharp criticism in some areas. It has been too conservative in responding to the increasing need for the regulation and monitoring of various sectors of the economy. For instance only after the banking crisis of 1965, did the government tighten the regulations in the Banking Ordinance, and it was not until after the stock market crash of 1973 that the Securities Commission was set up.

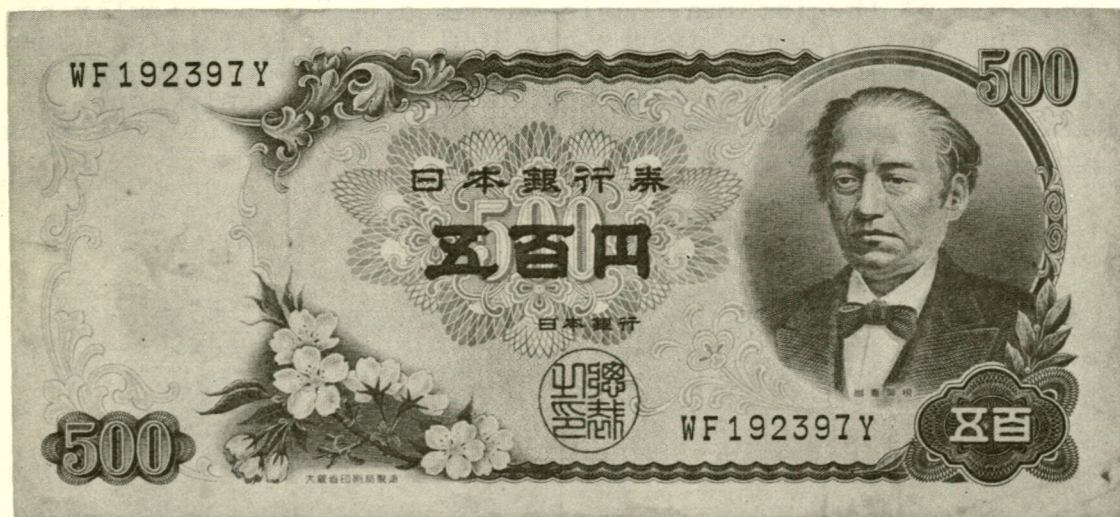
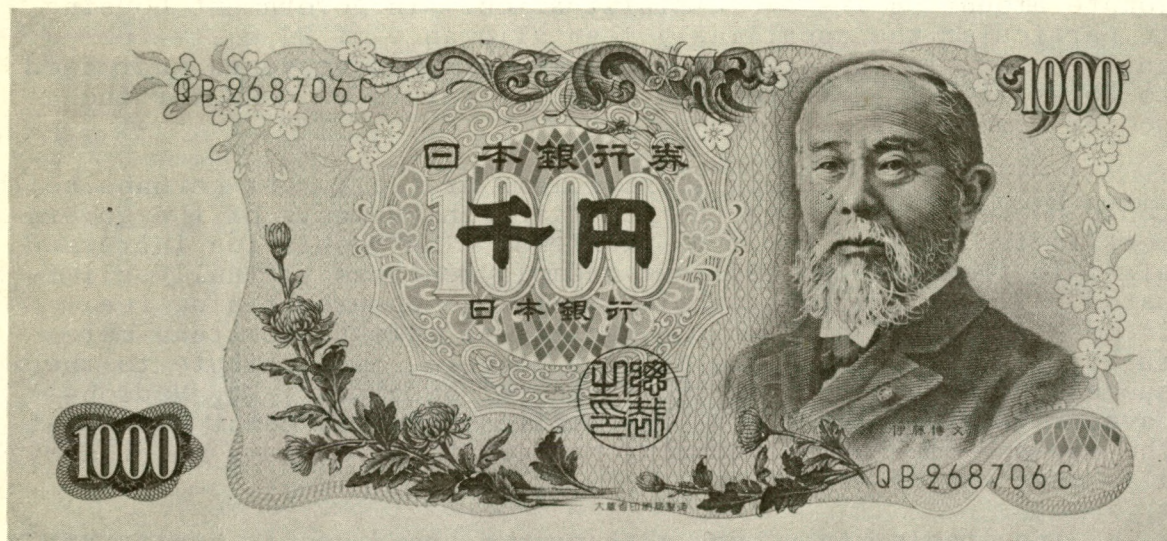
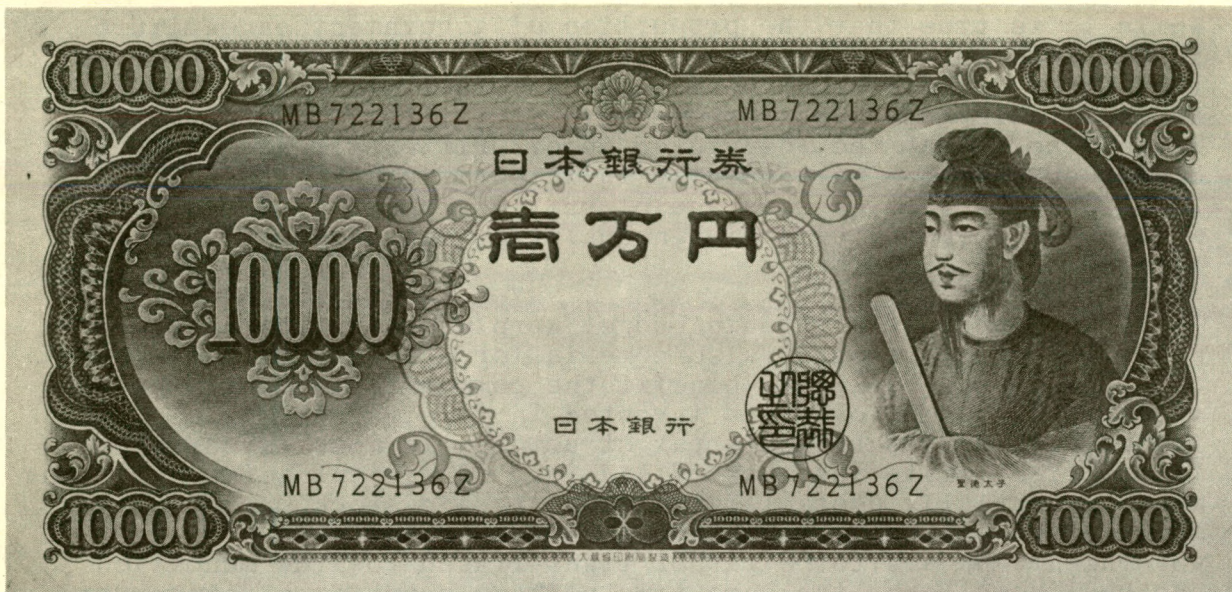
In its fiscal policy too, the government has lagged behind.

While it is true that the proportion of government expenditure in GDP in Hong Kong is similar to that in other Asian countries, the author believes that Hong Kong is relatively more affluent and well able to afford more welfare facilities. Furthermore, it is likely that the restricted opportunities for secondary and higher education - particularly in scientific subjects - will lead to an increasing shortage of skilled labour in the future, which will perpetuate income inequalities and hamper technical development in industry.

The apparently chronic budget surpluses and the consequent accumulation of reserves also come in for criticism; these funds could be used directly to benefit the community in Hong Kong rather than remain overseas invested in foreign securities. On the revenue side the income tax structure 'is most favourable to the rich' while the lack of any form of capital gains taxation makes potentially destabilizing property and stock-market speculation extremely lucrative. On the expenditure side the government appears to be rather tight-fisted towards education and health while at the same time perhaps spending a disproportionate amount on its own administration. In government housing in particular the appallingly mean allowance of 24 sq.ft. per adult - "double the size of a grave" - in recent years increased to 35 sq.ft., illustrates how much has yet to be done for the poorer members of society.

All in all Dr Cheng's criticisms are fair, but perhaps he could better acknowledge the positive achievements of the government in the face of enormous problems. The population increased six-fold from 1945 to 1971 yet unemployment was virtually eliminated by 1960. Rapid economic growth has ensured rising real incomes and the fact that the quality of life - rather than mere survival - is becoming the subject concern, is a tribute to the success of Hong Kong. As the Financial Secretary, Mr. Haddon-Cave, recently pointed out, the public sector dare not expand at the expense of export-producing sectors in an economy which above all, must export or die.

Inevitably, in a book with such a broad scope, errors creep in and some of the information is out of date; in particular he states that new currency issues are 100% backed by foreign assets but this is no longer the case, and there are one or two errors in the statistical tables relating to the money supply, but generally the book is a readable elementary manual for Hong Kong.



JAPANESE BANKNOTE PORTRAITS

SHOTOKU TAISHI, crown prince and regent, is famous both as the author (604 A.D.) of a 17-article code of injunctions based on Buddhism and Chinese Confucian precepts, and as the originator of a large official mission to China in 607, the first of many such overseas study tours. On a more light-hearted note he had the splendid temerity to phrase a letter to the Chinese ruler, "From the Emperor of the Rising Sun to the Emperor of the Setting Sun ..."

ITO HIROBUMI (1841-1909), one of the outstanding leaders of Meiji Japan, participated as a young samurai in the unsuccessful attack on the British legation in Edo (Tokyo) in 1861, went to England in 1863, and was instrumental in the first overthrow of the shogunate in 1865. As a member of the Iwakura Mission he studied foreign currency systems. On his return he and the Finance Minister, Okuma Shigenobu, unified Japan's heterogeneous currency, adopted the decimal system, and made the yen the standard coinage. The value of the yen was initially set equivalent to the Mexican dollar used in the international trade of East Asia at that time, worth about US\$0.50. Ito was also responsible for the purchase of the Hong Kong mint and its installation at Osaka. From 1873 to 1878 he held the key post of Minister of Industry; he held office as Prime Minister four times between 1885 and 1901, and later became president of the privy Council. After serving four years as resident-general in Korea he was assassinated by a Korean while travelling in Manchuria in 1909.

IWAKURA TOMOMI (1825-1883), another leading statesman of the Meiji Restoration, is best remembered as the head of the Iwakura Mission (1871-73) to the United States and Europe to seek a revision of the treaties with foreign powers which would enable Japan to raise import and export duties, thereby relieving the government of the embarrassing financial burdens it had contracted to the daimyo and the samurai. Although the mission was a success in other ways, it failed in its financial objectives, and perhaps fortunately, because as a result the government was obliged either to raise direct taxes (which proved to be out of the question) or reduce expenditure on pensions. The commutation schemes introduced for this latter purpose between 1873 and 1876 played a critical role in converting an unproductive class of possibly two million (including dependents) into a new and influential class who, some historians have argued, formed the backbone of Meiji entrepreneurship in banking, commerce and industry.



ASIAN MONETARY MONITOR

is published by

Asian Monetary Monitor Ltd.,
P.O. Box 20724, Causeway Bay,
Hong Kong.